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SUMMARY OF TESTIMONY OF PANELISTS ON TAX REFORM TOPICS

AT

PANEL DISCUSSIONS, FEBRUARY 5 TO FEBRUARY 28, 1973

HELD BY THE

COMMITTEE ON WAYS AND MEANS

PREPARED BY THE STAFF

OF THE

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CONTENTS

PANEL NO. 6—MINIMUM TAX AND TAX SHELTER DEVICES (FEBRUARY 20)

PANEL NO. 7—PENSIONS, PROFIT-SHARING, AND DEFERRED COMPENSATION (FEBRUARY 22)

PANEL NO. 8—AN ALTERNATIVE TO TAX-EXEMPT STATE AND LOCAL BONDS (FEBRUARY 23)

PANEL NO. 9—NATURAL RESOURCES (FEBRUARY 26)

PANEL NO. 10—ESTATE AND GIFT TAX REVISION (FEBRUARY 27)

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[2] Prepared statement coauthored by Prof. James C. Cox, University of Massachusetts.

PANEL NO. 11—TAXATION OF FOREIGN INCOME (FEBRUARY 28)

INTRODUCTION

In a press release dated January 24, 1973, the Committee on Ways and Means announced plans to conduct extensive panel discussions and public hearings on the subject of tax reform. It was announced that the panel discussions would begin on February 5 and that the participants in these panel discussions would include only those witnesses that had been specially invited by the committee. It was also announced that the second phase of the public hearings on tax reform would begin immediately upon conclusion of the panel discussions—subsequently announced to begin on March 5.

Panel discussions

The panel discussions involved only the enumerated specific areas of tax reform, as listed in the table of contents. The procedure followed in the panel discussions was for the panelists to submit in advance a prepared statement to the committee, but to summarize their statements orally before the committee. At the conclusion of the summaries of all of the panelists, there was a period of discussion among the panelists on the positions they took in their statements. Then, the committee members questioned the panelists either individually or as a group. This is a summary not only of their prepared statements before the committee but also of comments made during any part of the panel discussions.

General public witnesses

Although the panel discussions involved only certain specific areas of tax reform, it was announced that the second phase of the hearings would not be confined to those areas but would encompass all areas of the Internal Revenue Code, particularly concentrating on the following major subjects as listed in the press release:

I. Estate and Gift Tax Revision.—This category would include but is not limited to proposals for taxing gains at death, a carryover basis of property transferred at death and other alternative treatment for transfers at death, unification of estate and gift taxes, transfers involving generation skipping, changes in the unlimited contribution deduction, increasing the size of the marital deduction, changing estate and gift tax rates and exemptions, problems of liquidity of paying estate and gift taxes, and the estate and gift tax treatment of life insurance.

II. Treatment of Capital Recovery for Tax Purposes.—This includes but is not limited to proposals with respect to the investment tax credit, additional first year depreciation allowance, accelerated depreciation (including the 20-percent variance allowed under ADR) and the amortization provisions having expiration dates (rehabilitation—low-income rental, pollution control, railroad rolling stock, coal mine safety equipment and on-the-job training and child care facilities), and amortization of railroad grading and tunnel bores.

III. Taxation of Capital Gains and Loses.—This category would include but is not limited to a discussion of the holding period for capital gains, the alternative tax for individuals, the level of exclusion (and possibility of varying it with the period the asset is held), the capital gains tax rate for corporations, capital loss carrybacks and carryovers, and the tax treatment of timber, cattle, coal and iron ore royalties, and patents. (For tax treatment of lump-sum pension treatment, see category below on pension and profit sharing plans.)

IV. Tax Treatment of Real Estate.—This category would include but it not limited to depreciation method and life (including any distinction for this purpose between borrowings and equity), recapture rules for excess depreciation and the treatment of interest and taxes during the period of construction.

V. Natural Resources.—This category includes but is not limited to the rate of percentage depletion, intangible drilling expense and the deduction for development and other exploration costs.

VI. Farm Operations.—This includes but is not limited to the treatment of development costs in the case of fruits and other food products with long development periods, the deduction of farm losses, and so-called hobby loss operations.

VII. Personal Property Leasing.

VIII. Treatment of Interest Deductions.—This includes but is not limited to consideration of the present provision providing a limitation on the extent to which investment interest can be taken as a deduction, the interest deduction for home mortgages, etc.

IX. Tax Treatment of Limited Partnerships.—This includes, for example, considerations involving the basis for nonrecourse loans.

X. Minimum Tax.—This includes but is not limited to a consideration of the exemption level, the rate of tax, the allowance of a deduction for the regular or individual corporate income tax, and the possibility of adding other preference items to the base of the tax.

XI. Tax Treatment of Employee Stock Options.

XII. An Election to Issue Taxable Bonds with a federal subsidy as an alternative to tax-exempt State and local bonds.

XIII. Taxation of Foreign Income.—This includes but is not limited to consideration of the foreign tax credit (including consideration of the per-country and overall limitations), the deferral of income of controlled foreign subsidiaries, the tax treatment of Western Hemisphere Trade Corporations, whether the present exclusion of "gross-up" on dividends of less developed country corporations should be continued, tax exemptions of ships under foreign flags, DISC corporations, the exclusion of income earned in U.S. possessions, and the exemption for income earned abroad by U.S. citizens.

XIV. Pension and Profit Sharing Plans and Other Deferred Compensation.—This includes but is not limited to vesting, eligibility requirements (age and service) and portability, funding and termination insurance, deductions in the case of self-employed persons, closely-held corporations, subchapter S corporations, and professional corporations, tax treatment of lump-sum pension and profit sharing payments and deferred compensation plans of exempt organizations and governmental units.

XV. Tax Treatment of Political Contributions.—This includes but is not limited to the tax treatment of gifts of appreciated property and earnings on funds held by political organizations.

XVI. Corporate Tax Provisions Not Included Specifically Elsewhere.

XVII. Special Industry Tax Problems.—This includes but is not limited to the bank holding company tax provisions, the tax treatment of cooperatives, the tax treatment of financial institutions (including mutual savings and savings and loan associations, and credit unions) and the tax treatment of subchapter S (or small) corporations.

XVIII. Tax Treatment of Other Items Specially Affecting Individuals.—This is intended to include but is not limited to converting deductions into credits, possible consideration of deductions outside of the standard deduction (for example, the medical expense deduction, the deduction for non-business casualty losses, etc.), limitations and modifications of existing deductions, withholding on dividends and interest, the dividend exclusion, the exclusion of group term insurance, the exclusion of sick pay, and the tax treatment of losses on nonbusiness guarantees.

XIX. Tax Treatment of Foundations and Charitable Contributions.

XX. Tax Simplification.—The intent here at this point is to deal with proposals for simplification in the tax law without major substantive changes in the underlying provisions. Areas in which the staffs have already done a considerable amount of work toward tax simplification include the present annuity rule, the retirement income credit, the sick pay exclusion, moving expense deduction, section 367 (advance approval for tax-free exchanges involving foreign corporations), child care deduction, accumulations trust (throwback provisions) and the so-called deadwood or tax simplification bill introduced in the last Congress by Chairman Mills. Tax simplification proposals presented in the public testimony, of course, need not be limited to these areas.

SUMMARY OF TESTIMONY OF PANELISTS ON TAX REFORM TOPICS

PANEL NO. 1—OBJECTIVES AND APPROACHES TO TAX REFORM AND SIMPLIFICATION

Professor Boris I. Bittker, Sterling Professor of Law, Yale University, New Haven, Connecticut:

Tax simplification

Addresses primarily the problem of tax simplification. Points out that many of the complexities in the tax law are the result of a number of policy decisions which are not likely to be changed. For example, there is the decision that income will only be taxable when it is "realized," which requires the existence of numerous rules concerning the concept of realization. Other complicating factors included cash basis accounting, treatment of the corporation as a separate entity, the progressive rate structure, the reduced rate for taxation of capital gains, and multi-purpose tax provisions which attempt to raise revenue while at the same time furthering certain economic or social objectives.

Provisions applicable to mass of taxpayers

Appeals for simplification of those provisions which apply to the great mass of taxpayers, indicating that many of these provisions are unnecessarily complex. Since, for example, section 214 of the Code allows a deduction for dependency care expenses that are "incurred" on a month-by-month basis, and individuals generally account for their expenses on a yearly basis and use the cash method of accounting, concludes that much confusion could be eliminated if the deduction under section 214 were allowed on the same basis.

Suggests a systematic study of the sources of misunderstanding and error in "mass" tax provisions. Such a study could begin with a tabulation of the questions put by taxpayers to the taxpayer assistance offices of the Internal Revenue Service.

Token reform

Cites so-called "token" reform measures as another source of needless complication. For example, most of the income raised by the minimum tax provisions stems from the capital gains exclusion and percentage depletion. Suggests that reform of these areas, coupled with repeal of the minimum tax provisions, would be preferable to "tinkering" with the minimum tax. Argues that the mere existence of the minimum tax provisions is undesirable because it might tend to forestall "fundamental" tax reform.

Private legislation

Cites the existence of private legislation which is couched in general terms as a further complicating factor in the tax laws. Suggests that

where private legislation is included in the Code, it might be desirable to specify a termination date so that the private provisions do not remain there indefinitely.

Equity versus simplification

Indicates, in response to a question from the Committee, that in some instances the goals of tax equity and tax simplification might be in conflict. For example, if the standard deduction were to be increased, this would further the goal of tax simplification, but might hinder the goal of tax equity because taxpayers with substantial personal deductions in a particular year could be treated the same under the tax laws as taxpayers with no such expenses who elected the higher standard deduction. States that this problem probably could not be cured by providing that taxpayers who elected the standard deduction would pay tax at a higher rate, because there would still be the problem with a high standard deduction that taxpayers taking the deduction would vary widely as to their actual economic circumstances.

Other comments

States, in response to another question, that it is probably unlikely that the Supreme Court would move into the tax field and bring about tax reform under the auspices of the equal protection clause.

Indicates that there would be difficulties with a suggestion to publish the amount of tax paid by corporations and individuals. Merely publishing this final figure would be misleading in some cases and would put great pressure on certain individuals and corporations to make public additional information.

Indicates that the mechanism used for investing abroad should not result in tax differences, and favors taxation of the income of American-owned foreign subsidiaries on a consolidated basis. Indicates, in theory, that foreign taxes should probably be treated as a deduction, rather than a credit, but points out that a good many investments have been made on the assumption that the foreign tax credit is firmly entrenched in the Code.

Dr. Joseph Pechman, Brookings Institution, Washington, D.C. (Panel No. 1):

General approach

States that the income tax laws could provide both more equity and additional revenues if a more comprehensive definition of income were adopted. Testifies that the effect on distribution of income and wealth of this country with the present tax system has not been sufficient and that the progressivity of the tax system should be increased rather than reduced.

Proposals

Provides a detailed graph showing that tax liabilities could be increased by $77 billion by removing most of the preference items and adopting a comprehensive income tax. Believes that the adoption of a comprehensive income tax would make the most sense on equity, economic, and administrative grounds, but feels that such a revision would be politically impractical. Presents three other reform packages which, although less comprehensive, would increase revenues

from $3.1 billion to $10.2 billion a year. Favors using a portion of this additional revenue to provide a reserve for increasing Federal expenditures or reducing the tax rates or a combination of both.

Agrees with Professor Surrey that each particular tax provision should be examined to determine if it accomplishes its intended objective with the least amount of cost. Agrees that economic growth is an important factor in considering changes, but feels that many provisions which are presently intended to spur economic growth really do not achieve this objective.

Comments on some of the specific revisions contained in the three various packages he presented to the Committee. States that he would not favor eliminating the deduction for medical expenses because a family with unusual medical expenses does not have the same ability to pay as one without these expenses. Favors taxing all realized capital gains at ordinary income rates. Disagrees with Professor Smith's statement that an increase in capital gains tax would have a catastrophic effect on savings and investments in the stock market and states that the incentive for investment depends instead on the health of the economy. States that he would retain the charitable contribution deduction but suggests that a floor be established allowing a deduction only to the extent that contributions exceed 2 or 3 percent of a taxpayer's net income.

Foreign corporations

Agrees with Professor Surrey's statement that deferral of tax on the income of a foreign corporation controlled by a U.S. person should be eliminated. Feels, however, that the foreign tax credit should be retained.

Estate and gift

Suggests, in response to the question of estate and gift tax reform, that the estate and gift tax laws should be strengthened so that they yielded more revenue. Favors integration of the estate and gift tax into one tax. Belives that transfers in trust should be taxed at least once each generation.

Social security

Suggests that the committee re-examine the social security system to determine whether it is really an insurance system. Views our present system as not an insurance scheme but rather an inadequate transfer tax scheme which needs revision. Comments in response to questioning that he would be willing to have the United States contribute out of the general funds that portion of the social security payments which is not in truth an insurance or retirement system.

Professor Dan Throop Smith, Hoover Institute, Stanford, California (Panel No. 1):

General propositions

Makes several general propositions about the tax laws. Testifies that under the existing circumstances, inadequate revenues are desirable because they reinforce the efforts to bring Government expendiures under control. Second, suggests that more Government expenditures and new programs may not provide the best way of dealing with many

of our urgent social problems. Third, suggests the adoption of a value-added tax, although not at the present time, since it would increase Government revenues and thus Government spending.

Criteria for judging taxes

Lists several criteria for judging taxes:

(a) Taxes should be understandable.

(b) Since all taxes are bad, the higher the rate of any tax the greater the strain on it. Even a least bad tax may become very bad at high rates.

(c) The tax law should take into consideration the tax discouragement to savings and investment.

(d) The redistribution of income or wealth is not an inherent or necessary part of tax theory or policy.

(e) Though some degree of progressivity in taxation appears to be generally desired, it does not follow that each and every tax should be accepted or rejected on the basis of its progressivity.

(f) An analysis as to the effects of Government finance on the distribution of income must take into account the amount of benefits received from Government expenditures as well as the burden of taxation. A study last year showed that the benefits were far larger in proportion to income at the lowest income levels with a dramatic and smooth reduction through the moderate to the highest income levels.

Recommendations

Comments on three specific aspects of the Federal tax laws. Advocates a sliding scale for inclusion of capital gains in taxable income. Feels this would free frozen investments and permit capital to move into more productive uses. Second, advocates the retention of the asset depreciation range of calculating depreciation. Third, advocates the present system for the taxation of foreign subsidiaries. Indicates that the evidence seems clear that foreign investment is not generally made at the expense of domestic investment and that employment in U.S.-owned plants abroad does not represent a loss of employment here. Thinks that the removal of foreign tax credit would be more destructive than the elimination of deferral. Also, feels that the present section 482 regulations place U.S. business at a competitive disadvantage.

Comments on other specific items:

(a) It is important to give some significant relief from the double taxation of corporate income and dividends.

(b) Divergencies between taxable income and financial income cause unnecessary complexity and controversy.

(c) The retirement income credit and the throwback rules for accumulation trusts are specifically in need of simplification.

(d) Recapture on real estate depreciation should work the same as for equipment. Also, some of the special financing arrangements on real estate seem designed principally as tax shenanigans. The proposal to relate depreciation allowance to debt amortization has some appeal.

(e) The minimum tax is a complicated and indirect way of dealing with situations which might better be approached directly or left alone.

(f) The financial position of the States and the adoption of revenue sharing suggests that a direct approach to removal of tax exemption for future municipal bond issues might be made again.

Foreign subsidiaries

States that he believed the evidence supports the proposition that foreign subsidiaries make possible the continued export of component parts and finished goods to round out a product line. Therefore, on balance, he believes that foreign subsidiaries contribute to the creation of jobs in the United States.

Capital gains

Indicates that he believes that the concept of capital gain should be tightened because it has been subject to gross abuse, particularly by various pools and syndicates. States that recapture should be expanded to any situation of capital gain arising out of a previous deduction. Thus, he would go beyond straight-line depreciation recapture in the real estate industry.

Estate and gift taxes

Indicates that the multiple trust rules should be tightened and that that rules on generation skipping should also be tightened. Does not agree with the proposals for the integration of gift and estate tax because of the importance of the present value of money.

Maximum tax

Suggests that the 50-percent limitation on earned income was a good precedent for other income and would deter taxpayers from seeking tax shelters.

Social security

Also states that he views the traditional Social Security programs as a form of spreading earned income over a lifetime and, therefore, he would not change the present system of imposing the Social Security tax.

Professor Stanley S. Surrey, Harvard Law School, Cambridge, Massachusetts (Panel No. 1):

Basic objectives of tax reform

Fairness in the tax system.—Believes that the basic objectives of tax reform are to achieve greater fairness in the tax system and to restore efficiency and economy in government expenditures. Believes that the tax system is fair only if it reaches all income. Asserts that today many, especially those well-off, are provided with escapes from tax, through "tax shelters." Feels that tax escapes have a corrosive effect on the entire tax system, and offend fairness and decency.

Efficiency and economy in government expenditures.—Says that tax escape provisions are in reality expenditures of government funds through the tax system. Maintains that special tax provisions have nothing to do with the essentials of an income tax, but are methods of spending government funds, and are intended to induce certain responses. Doubts that Congress would vote many direct subsidies in lieu of tax subsidies. Believes that special provisions give upside down

assistance so the wealthier receive the greater subsidies and the poorer receive none. Believes that tax subsidies amount to $50 to $60 billion or about a quarter of the regular budget and are larger than all direct subsidies. Says that these tax subsidies are immune from the scrutiny given to programs under the regular budget, and feels that this is bad tax and budget policy.

Current escape from tax

Individuals.—Indicates that data on individual high income taxpayers shows that, in 1970, 106 individuals with adjusted gross income above $200,000 paid no income tax, and 394 individuals with AGI over $100,000 paid no tax. Also another 318 individuals over the $100,000 level paid a minimum tax but the average rate was no higher than 4.42 percent for this group. Believes that more data is required from the Treasury on individuals who have high actual incomes and pay no or little tax. Says that data on effective rates by income tax brackets shows lower effective rates are paid than the statutory rate tables require.

Corporations.—Says that data shows that effective rates of tax paid by corporations are much lower than the 48 percent statutory rate. Additionally, points out that corporate income tax as a percentage of full employment GNP has dropped from 1964 to 1973 while individual income tax has remained a constant percentage and payroll taxes have almost doubled. Says detail is needed on corporate situations to explain why low taxes are paid.

The causes of tax escape—tax expenditures.

Believes that the reasons why individuals and corporations can escape tax are detailed in "Estimates of Federal Tax Expenditures" issued by the Ways and Means Committee on October 4, 1972. Emphasizes the statement in the document that it is to "provide information as to the economic benefits provided by the tax laws to the various sectors of the economy." Feels that the tax provisions listed in this document cause certain well-to-do individuals and large corporations to pay little or no tax. Comments that the differences between tax expenditures and regular budget expenditures are that the regular budget is a matter of public knowledge, and regular budget subsidies are on a before-tax, not an after-tax basis. Believes that the hearings, by covering the subjects listed in the tax expenditure publication, focus on causes for tax unfairness and waste in government expenditures.

A suggested framework for hearings

Suggests questions which should be asked in the tax reform hearings, including: which tax programs can be dropped without substituting another type of government aid; which programs can be changed from tax expenditure to direct expenditures to improve equity and efficiency; which programs should be changed but must await development of a direct expenditure program; which programs are most efficient and effective as tax expenditure programs. Suggests additionally that proponents for retention be required to make a case for continuance of the tax program. Recommends asking what the United States is obtaining in return for the tax benefits and what policies and objectives of the United States are being advanced by these tax programs.

Suggests translating tax programs into direct expenditure terms, and comments on the following tax provisions:

State and local bond interest.—Suggests asking whether we would pay banks and high income individuals $3 billion so that they would turn over $2 billion to state and local governments. Favors a proposal to allow State and local governments to issue taxable bonds on which the Treasury would pay half the interest.

Low income housing.—Suggests asking whether we would pay out funds to well-off people so they would turn over some of the dollars to developers as their compensation, but would themselves keep enough to provide a commission that can come to over 140 percent. Points out that HUD already subsidizes these programs, and asks why a tax subsidy should be added to the direct subsidy.

Rapid depreciation.—Suggests asking whether we would directly pay a small company $1,000 to help purchase a machine but pay larger companies $2,200 to buy the same machine. Favors dropping rapid depreciation entirely. Would confine any tax assistance to the investment credit.

Foreign investment.—Suggests asking whether we would directly pay significant amounts to locate productive facilities abroad, amounts which become larger the greater the size of foreign operations.

Exporting.—Suggests asking whether we would pay significant amounts every time we negotiate new trade arrangements with the Russians or Chinese or whenever we devalue our currency. Favors dropping DISC entirely; believes ludicrous windfalls are now obtained under DISC.

Suggests that if tax assistance is appropriate, it be confined to those with a real stake in the industry and not a desire to shelter income. Suggests restricting the tax benefit to income from the industry activities. Alternatively suggests a stronger minimum tax, a stronger limitation on the interest deduction, and allocation of deductions.

Tax deferral.—Observes that tax deferral is very important to persons who look for tax shelters. Says that tax deferral gives an interest-free loan, a very valuable benefit, and that tax shelters are built on tax deferral. States that three things make a tax shelter work. First is a tax deferral through a quick write-off through depreciation, amortization, or intangible drilling expenses of all money invested. Second is the ability to write off money borrowed in addition to that invested. Third is a conversion of deferred income to capital gain.

Dr. Norman Ture, Economic Consultant, Washington, D.C. (Panel No. 1):

General

States that the object of tax reform should be to make the tax laws fairer, simpler, and less of an impediment to economic efficiency. Indicates that taxes are imposed to raise revenues because the government uses some of the economy's production capacity to carry out its functions and operations. The basic purpose of the taxes levied by government is to reduce the private sector's claims on the economy's production capacity. Every tax has the effect of raising the cost of something to the private sector, and the effectiveness of a tax, in terms

of its basic purpose of transferring claims on productive capacity to the government, depends on how responsive households and businesses are to these increases in costs. As no two taxes have the same initial effect on the costs facing the private sector, argues that in choosing among them the central questions are (1) wsat cost will each increase and how much, (2) what will these respective increases in cost do to the amount and kind of claims exercised by the taxpayers, and (3) are these the results that are desired.

Points out that in the past, it has been generally argued that the taxes which are best are those which least change the relative costs determined in the marketplace and which least affect household and business decisions about how the resources at their disposal will be used. Similarly, those taxes which are best are those which increase all costs to the private sector in the same proportion. This is still true today.

Tax system in regard to savings vs. consumption

As an illustration of these questions, discusses the anti-saving bias of the existing tax system. Points out that the tax system taxes both the current income of persons and the future return on that saving, which increases the cost of private saving relative to the cost of consumption. Argues that the investment credit, accelerated depreciation, shortening of useful lives for tax depreciation purposes, etc., somewhat reduce but do not eliminate the extra cost of saving compared with consumption imposed by the income tax. Argues that these provisions do not afford a subsidy for savings and investment but instead reduce somewhat the income tax bias against saving and capital formation. The bias against saving and capital accumulation is compounded by graduation of the income tax rates through differentiating the basic anti-saving bias on the basis of the amount of taxpayer's income, not on the amount or proportion of their incomes allocated to saving. Argues that the inference to be drawn from this is not that the differentially higher tax on saving than on consumption eliminates savings but rather that it reduces the amount of saving out of any given income compared to what it would be under a neutral tax.

Progressive tax structure.—Argues that with a graduated tax on income, the more efficient and productive an individual is, the greater the tax on the rewards he receives for his contribution to total output. Graduation therefore imposes an increasing cost on improving one's efficiency and productivity.

Capital gains tax.—States that the capital gains tax is not imposed as the gain accrues but only when it is realized. Argues that the occasion for the tax is not merely the accrual of the gain itself, but the transfer of the asset as well. Taxing capital gains not only increases the relative cost of savings but also increases the cost of changing the composition of one's wealth. It therefore must reduce the frequency of transfers and impede the ready shift in the allocation of saving, thereby impairing the efficiency with which savings are allocated among alternative uses.

Anti-saving bias.—Argues that a tax system with a basic bias against savings would be appropriate, if at all, only in a country which enjoyed capital superabundance in the sense that adding to the existing

stock of capital would add nothing at all to total output. This is not the case in the United States. Barring this circumstance, the tax system should certainly not increase the cost of saving and of capital accumulation in greater proportion than it increases the cost of consumption. If it does, such a tax system is unfair and erects a barrier to efficient use of the economy's production capacity.

Argues that the anti-saving bias of taxation in the United States is in part a consequence of an accumulation of *ad hoc* provisions over a long period of years. Argues that in orienting the tax system to provide some sort of equality of tax liability on "equally" situated taxpayers and suitably different tax liabilities on "unequally" situated taxpayers, tax policy has tended to burden unfairly those with a relatively strong saving preference and to favor those with relatively high consumption propensities. Furthermore, the present philosophy expressed in the tax system has been used to redistribute income and wealth from the affluent to the needy. Argues that economists have long past given up the conviction that such redistribution, to the extent it were effective, would increase the total utility or efficiency of the society.

Argues that the redistributive tax-transfer system of the postwar era has not in fact changed the shape of the distribution of income. Argues that to a large extent the tax part of the tax-transfer system has consisted of taxes which heavily penalize saving compared with consumption. Argues that this has resulted in a retardation in the growth of capital which has in its turn resulted in the pretax return per unit of capital to be higher than it would otherwise while the pretax wage rate of labor has been lower than otherwise. Argues that an elimination of the tax bias against savings would result in a long-term higher rate of private saving, faster accumulation of capital, more rapid expansion of total output, expansion of employment opportunities, and a more rapid increase in labor's productivity and real wage rate.

Argues that a tax that increases the cost of saving and consumption in equal proportions must either allow a deduction of current saving from current income or exclude the future income produced by that saving from the future tax base. To be neutral, the tax cannot be imposed on both, even if it is imposed at a reduced or preferential rate on one or the other since any such treatment increases the relative cost of saving. By the same token, the tax must be fully imposed on one or the other because failure to do so reduces the relative cost of saving. To achieve full tax equality between saving and consumption all private sector saving should be deductible from the income tax base while private saving should be allowed to have a 100 percent write-off of the cost of production facilities in the year in which they are acquired.

Constructive tax revision

Also argues that a major objective of constructive tax revision should be to eliminate or at least moderate the graduation of income tax rates. This could be initiated by a program of periodic reduction of income tax rates above the first four brackets as a first step, while extending the present 50 percent effective tax rate on earned income of all individuals. Also, proposes the elimination of the corporate income tax by attributing the corporation's earnings to its

shareholders and taxing them only under the individual income tax. Furthermore, the attributable corporate earnings should be reduced by the amount of the corporation's saving. Partial integration could be accomplished by revising the tax treatment of dividends under the so-called "gross-up" approach. Individual shareholders under this approach would attribute corporation income tax deemed to have been paid to the dividends they receive, compute their tax on their total taxable income including the grossed-up dividends, and claim a tax credit equal to the amount of the corporation income tax included in the grossed-up dividends. Also calls for the elimination of the capital gains and losses entirely from the tax base.

Finds no social policy objective in trying to structure the tax law to make it more costly for the household and for the business to save than to consume.

Does not recommend a consumption tax, and does not find that the value added tax is a consumption tax. In commenting on Dr. Pechman's comprehensive income tax base, urges that the consequences of this proposal be studied in terms of what will it do to the relative cost of saving and consumption. Argues that this proposal will increase the cost of saving relative to consumption.

Believes that a direct subsidy would have to be administered by the government with resulting increases due to administrative costs.

Burke-Hartke bill

Indicates a belief that the Burke-Hartke bill is the wrong approach and embodies some assumptions about how multi-national corporations conduct their affairs and the effects of that which other kinds of analysis do not suggest is the case. Believes that there is a very good argument for full implementation of the territorial principle which rests on the presumption that income that is generated abroad using foreign jurisdictions' product capabilities and real production resources, involves zero costs for the United States and therefore is not an appropriate source of taxation under the U.S. tax law.

Estate tax rate

Recommends that the top tax rate for estate taxation purposes be lowered to 50 percent. Believes that if you impose the transfer tax at a high rate it will induce the disposition of property in a way that will minimize the tax, and in a way that makes the economy the loser.

Capital recovery

States that instead of depreciation, suggests there should be an immediate write-off for capital outlay. Insofar as the capital outlay is financed by borrowing, and the indebtedness is real, recommends that it is the full amount of that which represents the asset acquisition which should be deductible.

PANEL NO. 2—CAPITAL GAINS AND LOSSES

Harvey E. Brazer, Professor of Economics, University of Michigan, Ann Arbor:

Instruments and objectives

Believes that useful analysis of the tax law and proposals requires a clear statement of policy goals so that it is clear whether disagreement over proposals stems from differences as to the desirability of goals or the effectiveness of the proposals as instruments for attaining the specified goals. The instruments considered herein are the exclusion of one-half realized long-term gains, the six-month holding period, nonrecognition of gain on transfer by death or gift, step-up in basis at death, the alternative rate, and "statutory" capital gains. Economists may be better able than noneconomists to evaluate the effectiveness of alternative policy instruments.

States that the principal objectives of Federal tax policy on which the following analysis is based are: the equitable distribution of tax liabilities, avoidance of undesired distortions of resource allocation decisions, and the constraint of total demand to avoid inflation.

States that the "equitable distribution of tax liabilities" means the allocation of taxes should be determined by relative taxpaying capacity as measured by income. The question is then the appropriate definition of income. The purpose of the definition is to measure the relative economic well being of the tax unit. For this purpose, it should be comprehensive and should include the money value of "the increase in one's power to satisfy his wants in a given period." Consistent with the Haig-Simons definition, income is consumption plus the change in net worth over a given time period. Increases in the value of capital assets are clearly income within this definition for the purposes of taxation (although they are not necessarily income for other purposes such as the national income accounts).

Impact of present law

Estimates of the impact of present capital gains treatment (given existing behavior patterns) by Pechman and Okner indicate that excluded capital gains in 1972 amounting to 11 percent of expanded income represented unpaid tax of $13.7 billion or more than 13 percent of actual liabilities. The benefits of this treatment are unevenly distributed, representing less than 2 percent of income for income classes below $25,000 whereas for income classes over $100,000, the exclusion ranges from 20 percent to 40 percent of total income and the addition to liability ranges from 46 to 84 percent.

Arguments for special treatment

(a) *Statutory capital gains.*—States that for the most part, the capital gains treatment of iron ore, coal and patent royalties and timber results from the fact that the income is not significantly different from

that which results from the sale of iron ore, coal, etc., properties given the current level of tax rates.

(b) *Gains and losses on capital assets.*—Indicates that the principal arguments for special treatment of long-term gains are:

(1) Gains realized in one year that have accrued over a long period would be subject to unfairly high tax under a progressive rate system.

(2) In a period of inflation, capital gains are in part not "real" because they reflect merely an increase in prices and do not add to ones purchasing power.

(3) Gains or losses attributable to changes in interest rates are not "real" because they do not affect the amount of one's interest income.

(4) Taxing capital gains tends to "lock-in" investors and reduce the mobility of capital.

(5) Capital gains do not represent income created through production, are not included in the national income accounts, and therefore should not be taxed as income.

(6) Taxation of capital gains discourages risk taking, affects saving more than consumption, and hence is more likely to reduce investment. To the extent that taxing capital gains does hit saving it represents double taxation, particularly taxation of gains that reflect retained corporate earnings that have already been subject to the corporate income tax.

Believes that the above arguments are more compelling to those who believe taxes should be allocated among tax units on the basis of their consumption, thus exempting saving. If taxes are to be based on consumption, there is no justification for excluding the savings in the form of a capital gains—the exclusion of savings should be available without regard to the source of income. Considering the above specific arguments in favor of capital gains treatment, the following discussion indicates that while there may be some truth in each argument, the preferred remedy is not the present law treatment of capital gains or that the beneficial results from this special treatment are outweighed by the costs in terms of equity or foregone opportunities in the budget or alternative tax cuts.

States that the replies to the above arguments in favor of special capital gains treatment are:

(1) The "bunching" problem arises only for assets held more than one year. Therefore a 6-month holding period has no justification. A more appropriate answer to the bunching problem for assets held more than one year is to permit averaging over the number of years the asset has been held.

(2) Capital gains are not the only type of income that reflects inflation rather than increases in real purchasing power; virtually all income sources do. The distortions caused by inflation are increased when concessions are made to one type of income and not others, particularly when the concession is made to those who gain most or lose least from inflation, i.e., the owners of equity interests in business, real estate and other real property. Prefers to make adjustment for none rather than all types of income.

(3) The increase in asset values due to a fall in interest rates represents a spendable addition to net worth. The fact that interest income is unchanged is irrelevant.

(4) The lock-in problem is caused by the 6-month holding period, the "interest-free loan" aspect of deferring taxes, and the nontaxation of gain at the time of transfer by gift or at death. A return to the graduated inclusion rate which varies with the period the asset is held would intensify the lock-in problem.

(5) The fact that capital gains are not counted as income in the national income accounts indicates that the national income account definition of income is not appropriate as a basis of taxation; it does not indicate that capital gains are not income.

(6) Even if the favored treatment of capital gains does encourage risk-taking, saving, and investment, it does not follow that it does so sufficiently to justify a revenue cost of over $13 billion (more than three times the cost of the investment credit) and the other associated costs. More generous loss offsets would be both more equitable and more effective for encouraging risk taking. If encouragement is to be provided saving, there is no reason to confine the exemption of saving from tax to capital gains income. The "double taxation" arising from taxation of corporate stock which reflect retained earnings which have already been subject to the corporate tax does not justify the favorable treatment of capital gains.

Policy proposals

(1) Include in full in income subject to tax "all gains from whatever source derived."

(2) Gains accrued on assets transferred by gift or death to be deemed realized, with appropriate exemptions for intra-family transfers.

(3) Gains to be averaged over the holding period up to a maximum of 10 years (or fewer if required by compliance or administration).

(4) Liberalize limits on loss carryforwards and carrybacks against other income.

(5) Reduce maximum marginal rates on all income to 50 percent.

(6) If special incentives are to be provided in the tax system to encourage risk taking, saving and investment, provide them in a way that directly, openly, and uniformly rewards the desired activity.

Inflation adjustment

Suggests that there should be no tax difference in the case of common stock rising at 9 percent a year, 6 percent representing inflation and 3 percent improvements in earnings prospects, and a corporate bond that carries an interest rate of 9 percent, 6 percent of which represents expected inflation and 3 percent represents the real interest rate.

Suggests that if an individual is to be charged interest in the case of deferral of realization of capital gains, he will also have imputed income representing gain from postponement added to his income. This seems to be nothing more than an offset—a wash.

Concerning adjustments for inflation, argues that we cannot have an effective income tax that makes adjustments for inflation. An income tax can function only within a fairly narrow range of price

changes. The more we permit adjustments for inflation in the income tax, the less effective the tax becomes as an automatic built-in stabilizer that helps to contain inflation. Moreover, the more people to whom we extend adjustments for inflation, the smaller the public interest in containing that inflation.

International comparisons

Concerning the international comparison of capital gains treatment, one cannot make such a comparison by looking at tax rates in other countries. The definition of what is a capital gain is normally more narrow than it is in this country. So many of the things we treat as capital gains are taxed as ordinary income in these countries.

Concerning the taxation of gain on a small business at death, probably generous exceptions could be provided without undermining the basic principle.

Responses to questions

In response to a question concerning President Kennedy's 1963 recommendations to reduce the capital gains rate, indicates disapproval of that aspect of the recommendation. The justification was that it was necessary to reduce the inclusion ratio in exchange for the most important single element in tax reform, namely, constructive realization.

In response to a question concerning the need for other special incentives if capital gains treatment were eliminated, states that if capital gains were taxed as ordinary income, there would no longer be a case for the continuation of the corporate income tax. This combination of changes might provide a greater encouragement to investment than the current 48 percent rate with all the special features. But if additional incentives were necessary, they should be provided directly through the appropriations process rather than the Tax Code.

Suggests that, given the 1969 Act and the minimum tax, the alternative capital gains tax is of little importance.

Taxation of gain from residences

In response to a question concerning taxation of gains as well as losses on personal residences, suggests continuation of the present roll-over but no more than that. Argues that once the residence roll-over is completed, the gain is indistinguishable from any other kind. Concerning the inflation portion of that gain, suggests that a family whose home has appreciated is fortunate and is better off than families holding assets that did not appreciate in value or who did not have assets in the first place.

In response to the question of an individual whose residence has appreciated and buys a more expensive home should be exempt from tax whereas one whose residence has decreased in value and he is forced to sell and move into rental quarters be taxed, argues that we should distinguish between the value of the building and the likely increase in site value, which argues for taxing an appreciation in value or an increase in equity interest regardless of its source.

Capital and capital markets

In response to the question of whether there is enough accumulated capital available today to meet the needs of our economy at this time,

suggests that a partial answer is to look at the rate of capacity utilization which is not up to maximum. A second consideration is that capital investment includes more than the bricks and mortar approach in the national incomes accounts. Under the broader view, the concern with incentives to build factories and machinery, etc., is likely to be much reduced.

In response to a question about the extent to which removal or reduction of present treatment of capital gains would deter the movement of funds into the economy or the market, points out that in connection with Mr. Wallich's suggestion that taxation of gains at the current average rates would yield $20 to $40 billion a year, indicates that this represents 20 to 40 percent of the current individual income tax yield, making possible very drastic rate reductions which would probably increase the flow of funds in the capital markets.

Maintains that under the package of a 50-percent top tax rate, full inclusion of gains, constructive realization, general loss offsets, and averaging, saving and investment would be reduced somewhat but minimally and views the vast gain in equity as far more than offsetting such losses.

Statutory capital gains

In response to the question whether we should have capital gains for such things as cattle and timber, points out that one reason we have such types of income as iron ore or coal royalties, and gains on the sale of timber or livestock treated as capital gains is the fact that the difference in the law's treatment between ordinary income and capital gains puts a tremendous amount of pressure on what sometimes may be only very fine differences in degree between what might qualify as a capital gain and what might not. The problem is that with very large differences such as 50-percent exclusion and complete exclusion at death and high tax rates, these distinctions become very difficult to maintain. The answer is to tax all income without distinction between capital gains and other types and that takes care of statutory capital gains.

In response to the question how would we best increase the amount of capital formation suggests double or even triple the investment credit provided the right thing is done on capital gains.

Averaging

Concerning averaging for capital gains, suggests that it should not be retroactive. It would be prospective so that taxpayers could average over the full holding period since they would be on notice at the time of enactment that for all future gains there would be full averaging available on a 10-year basis. Averaging properly for gains at death might be more of a problem but could be solved.

Professor Richard A. Musgrave, Harvard University, Cambridge, Massachusetts (Panel No. 2):

Basis for taxing capital gains

States that taxing income is the basis at present for personal taxation, and under that concept, all accretions—including capital gains whether or not realized—belong in the tax base. Even if the tax base were to be consumption, then all income that is spent—irrespective of

its source—should be taxed. Neither view of the tax base is consistent with special treatment for capital gains.

Equity considerations

Indicates failure to tax capital gains equitably means failure to tax high incomes equitably, and this in turn will be reflected in increasing difficulties in the equitable collection of all other Federal revenues. Such failure makes it the dominant form of tax avoidance used by high income recipients. Preferential treatment of long holding adds to the inequities which result from deferral of taxation of such gains. Many or most of the domestic tax shelter problems are linked to the failure to tax capital gains as ordinary income.

Difficult issues must be faced

Suggests that the difficulties include (1) the lock-in effect from not taxing unrealized gains at death or as gift, (2) taxing accrued gains on negotiable assets (e.g., traded shares) (3) treating losses symmetrically with gains, and (4) adequate provision for averaging.

Taxation of unrealized gains may impose heavy burdens on family farms and enterprises, and special solutions may be necessary on family cases. In other cases, taxpayer needs a reasonable time period allowance to meet his tax liability without going through a forced sale.

Suggests that the committee should avoid being sidetracked from the basic issue by treating subsidiary issues like the alternative rate, the length of the holding period or restoration of the step-down structure of the 1930's.

Other policy issues

Suggests that capital gains reform should be undertaken in conjunction with other aspects of tax reform, and full taxation of capital gains should be accompanied by a reduction in top bracket rates, in line with the 50-percent rate on earned income.

Suggests that the Committee should separate the equity issues which are the basic objectives of tax reform from other questions, like the need for incentives for capital funds. Other ways can be used to encourage investment without resort to special capital gains treatment.

Suggests that tax should apply to real (rather than inflated) capital gains. If tax is levied only on realization, then making allowances for rates of inflation and the interest-free loan on tax deferral appears to support 100 percent inclusion of gains.

Believes that prospects are high that long-run expenditure growth will exceed the built-in revenue growth capacity of the present tax system. Capital gains tax reform should be a key part of legislation to increase the revenue raising capacity of the tax structure.

General

States that the general problem is to improve the present tax system so that the basic tax structure applies equitably to everyone. It would be a mistake to delay making fundamental changes just because it will not be possible to enact a perfect system. A system which is more perfect than the present one can be worked out. A more fair tax structure also would not build in tax disincentives for low-income people.

Makes no distinction between coal and iron ore royalties and Christmas trees for capital gains purposes because all capital gains should be treated as ordinary income.

Believes serious interference with the working of the capital market through the lock-in effect, cannot be avoided, if realized gains are to be taxed at 50 percent but we fail to tax unrealized gains at death.

Prefers to reduce the value of an estate by the taxes paid in the income tax settlement, including payment of capital gains tax. The income tax settlement should come prior to the estate tax settlement. This change does not involve an element of double taxation.

Unrealized gains

Considers liquidity problem at the time of death of a small business entrepreneur or a farmer to be unimportant relative to the total tax base. These people represent a small part of the base, and he believes it would be a mistake to avoid tackling the very large estates because of liquidity problems associated with the unrealized gains of small estates. Suggests exempting them or being as generous as is necessary.

States that with traded shares, there should be no difficulty in taxing unrealized gains because the valuation of shares takes place every business day, and it amounts to a substantial part of the total. The more difficult valuations—closely held or family businesses—can be taken care of at time of death or gift. The latter situations account for a minority of all assets.

Believes there would be less lock-in at any given tax on realized gains, if there also is taxation of unrealized gains at death.

Investment stimulation, economic growth, and equity

States that the present treatment of capital gains is an extremely clumsy, arbitrary, and inefficient way of stimulating investment. It is possible to provide an equitable way to tax income (including capital gains) and to provide investment incentives (at even higher rates than the present 7 percent investment credit) that are not structured to end up as benefits only to high income people.

States it is mistake to believe it is necessary to adopt provisions that are inequitable in the belief that they are necessary to stimulate economic growth. It is best to keep both objectives prominently in mind and to attack them directly. Patching provision after provision while avoiding the direct taxation of capital gains as ordinary income and taxing unrealized gains at death is avoiding the basic problems and complicating taxes.

Relating economic growth only to capital formation ignores other important stimuli to economic growth, such as, the skill level of the labor force (human investment) and technological progress. It is also important to retain social mobility, an open society and flexibility in our society. Thus, insofar as tax policy is concerned with growth, it ought to be concerned with growth with equity and doing it in a way in which these incentives do least damage to the tax structure.

States that the investment credit is desirable and is preferable to a general reduction or accelerated depreciation. There are types of credit which might be more potent than the present one and

which should be permanent, but capable of being adjusted up or down.

States that there can be as good investment incentives as there are now with a more equitable distribution of the tax burden by taxing capital gains at sale or death as ordinary income, an income tax structure with a 50 percent top rate on all income, and a 15 percent investment credit. Integrating the corporation income tax with the individual income tax is a policy goal which might introduce an added incentive to equity investment.

Capital gains tax and capital markets

Believes that the present tax treatment of capital gains locks in many investments which is a disincentive and reduces the flexibility of the capital market. By taxing realized gains and unrealized gains at death or gift, the lock-in effect would be reduced. This would not be a disincentive to invest because it would treat capital gains as all other private income. If private income taxation can be shown to be too high, the rate of taxation can be reduced.

Capital gains and losses

Capital gains and capital losses should be treated symmetrically, and if capital gains are treated as ordinary income, then capital losses are indistinguishable from net operating losses.

Exclusion rates

The greater the effect of inflation in raising the asset's value, the greater is the portion of the capital gain to be excluded from income. Believes that it is fair to make an inflation adjustment for capital gains purposes.

Tax deferral

The interest charged on any tax deferral would be a deduction from income.

B. Kenneth Sanden, C.P.A., Price Waterhouse & Co., New York, N.Y. (Panel No. 2):

States that to ensure an orderly flow of investment and viability in the capital markets, the tax system applicable to realized capital gains must continue to be founded on equitable and rational rules, preferably simple in application and administration. Greater taxation of capital gains is a real danger to our long-term economy and further shifts in reducing the differential between the taxation of long-term capital gains and ordinary income do not appear equitable and should be avoided.

Recommendations

Continue to distinguish long-term capital gains from ordinary income.—States that the basic rationale is to encourage the flow of capital to the securities market or into direct investment. Among the primary reasons for taxing capital gains more favorably are:

(a) Capital losses are limited in deductibility.

(b) Reinvested capital gains are taxed. To avoid the adverse affects on capital mobility through the so-called "lock-in", the repetitive capital gains tax should be at a lesser rate than applied to ordinary realized income.

(c) Partial double taxation on corporate investments is not adequately dealt with by the minor adjustment allowed on dividends received.

(d) Taxable gain reflects price level changes and not economic gain. Long-term capital gains are largely the effect of inflationary price level adjustments and not economic gains. Taxing the illusory gain at a more favorable rate is hardly preferential treatment, but merely an equitable realization of economic fact.

(e) Capital gains are accumulations of many years of income and would be bunched in one year except for the averaging effect of the preferential rate.

Continue to tax only realized gains.—Asserts that accumulation and mobility of capital is not enhanced by taxing unrealized appreciation.

Adopt a sliding scale for the inclusion of realized gains in taxable income based on the holding period of assets sold.—Notes that present law differentiates short- and long-term capital transacting on the basis of a six-month holding period. Concludes that this short holding period is in conflict with the reasons for continuing to distinguish long-term capital gains from ordinary income but is not conflicting if the assets were held considerably longer; that a sliding scale for inclusion of capital gains in taxable income would create greater equity and would appear to be less cumbersome than a price level adjustment mechanism; and that short-term traders should be differentiated from long-term investors and it seems as though a suitable short-term cut off might be one year. Suggests that the one-year holding period be phased in by one or two months over a number of years.

Suggests that gains realized beyond the one-year holding period be included on an annual sliding scale at reductions of, for example, 10 percent per year or alternatively by brackets of years and percentages, since too large a reduction for holding assets slightly longer may create temporary "lock-in" disadvantages. To be consistent, suggests that long-term losses be allowed to offset long-term gains on the same scale.

Eliminate the reduction in "earned income" attributable to the 50-percent capital gains deduction for maximum tax purposes.—Maintains that including the 50-percent capital gains deduction as an item of "tax preference" that reduces "earned income" to which the maximum tax may be applied appears completely inequitable, since the net effect of including the capital gain deduction as a tax preference is that people who work for a living pay higher capital gains taxes than those who live off their wealth.

Provide that gains as well as losses on personal residences should not be recognized for Federal tax purposes.—Maintains that, generally, residential profits are the result of very long-term investments and arise largely because of the inflationary reduction in the value of the dollar; that uncapitalized costs also enhance the ultimate value; and that complicated procedures and discriminatory limitations for sales by the elderly or where the proceeds are reinvested in another residence recognize these factors which increase residence value and attempt to alleviate the tax inequities. Suggests that additional relief would be provided by adoption of a sliding scale for taxing capital gains but that this would further accentuate already existing complexities. Recom-

mends that gains on personal residences not be recognized in any amount for Federal income tax purposes.

Allow amortization of purchased "goodwill" and similar intangible assets the sale of which has been taxed as a capital gain.—Notes that it is the view of the Internal Revenue Service that unless the useful life of an intangible asset can be estimated with reasonable accuracy no deduction for depreciation is allowable; that the Accounting Principles Board of the American Institute of Certified Public Accountants has issued its opinion APB No. 17 requiring the amortization of purchased goodwill for financial statement purposes; that the Accounting Principles Board recognizes that ideas, organizations, people, and things are being "used up" at an ever accelerating rate, and believes that the "value of intangible assets at any one date eventually disappears and that the cost of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefited." Suggests that the solution of the Board be equally acceptable for tax purposes.

Allow corporations to recoup currently capital losses at the same rate as capital gains are taxed, or in any event, extend the capital loss carryover provisions without limitation.—Maintains that the allowance of a deduction for capital losses only against capital gains and the carryover and carryback provisions of this loss for corporations is unduly restrictive and should be modified, and that present law creates a "lock-in" which discourages disposition of loss assets, and encourages the use of forced measures to create capital gains.

Comments on alternative suggestions for taxing long-term capital suggestions

Concedes that further refinements in this area are required in the interest of equity and that prices level adjustments, treatment of capital losses consistent with the capital gain treatment and taxation of unrealized appreciation, if adopted, might well approximate the present system coupled with the sliding scale approach. Maintains that they would, however, introduce into the tax laws complexities in application and administration of perhaps unmanageable proportions.

Rejects the proposal to include the entire gain from the sale of an asset in taxable income and lower the effective rate of tax. Maintains that ordinary investors would be treated as if they were gamblers unless we are willing to recognize either preferential rates or allowance of losses; that without the allowance of losses, the preferential rate must be retained; but agrees that the allowance of the losses coupled with the reduction in the total rate of tax that is paid, together should go a long way toward creating the equities that we need in the capital market.

Valuation as a problem

Concludes that the taxing of unrealized gain, because of the valuation problem, would lead to exception upon exception.

Liquidity as a problem

Avers that one of the principal problems confronting the plan to tax unrealized gains is where the money will come from to pay the tax. Concludes that if exceptions were not introduced, then administratively complex debt devices would be created.

Professor Henry C. Wallich, Yale University, New Haven, Connecticut (Panel No. 2):

Points out that in recent years, new circumstances and new economic insights have pointed toward a need for a continuation of some differential tax treatment for capital gains and losses, with perhaps easing the burden on some types of gains while increasing it on others. The new developments, in addition to the previous grounds of equity and economic effect, justifying differential treatment are (1) upsurge of inflation, (2) wider swings in interest rates, (3) mounting environmental and social needs, (4) increased volume of equity financing, and (5) new developments in the use of capital gains for current consumption.

Significance of mounting inflation for capital gains taxation

Asserts that the rate of inflation has been higher, since the last major changes were made in capital gains taxation in 1969, than any other nonwar period. From 1969 to 1972, the cost-of-living index rose by 18 percent while Standard & Poor's index and the Dow Jones averages were going up by 16 and 11 percent, respectively. The portion of a capital gain accounted for by the inflation factor cannot be regarded as "real income." Most people receive some protection against inflation—wage earners receive increases; aged receive Social Security benefit increases; and savers obtain an inflation premium through higher savings interest rates.

Wide swings in interest rates

Maintains that capital gains resulting from changes in capitalization (interest) rates do not provide a solid base for an income tax because the gain from such interest rate drops are not part of the national income. The extent to which part of such gains are absorbed by taxation and spent by the Government results in excess demand via the public sector since there are no goods and services produced or represented by such gains.

Need for savings

Concludes that the capital gains tax reduces the supply of savings because such gains tend to be predominantly saved. Preferential taxation of high-risk income is justified on the grounds that the originators of that income perform a valuable social function. The capital gains tax also involves double taxation by the corporate tax on earnings, including retained earnings, and later by a tax on the gain on the stock arising from increased retained earnings. If capital gains were taxed at ordinary income tax rates, the attractiveness of equity investment to high-income investors would be less.

Avers that the free flow of savings is affected by the lock-in effect of the capital gains tax. A short-term lock-in occurs due to the differential treatment for short- and long-term gains, and a lifetime lock-in arises from the lack of a capital gains tax on assets held until death. Some lock-in would occur even if short- and long-term gains were treated equally and if all gains were constructively realized at death, because of tax deferral benefits. Only continuous capital gains taxation on an accrual basis could eliminate all lock-in impact.

Shift toward equity financing

States that the shift toward increasing equity financing since 1968 reflects the strong overall demand for savings plus the concern about over-reliance on debt and the high levels of interest rates on corporate bonds.

Liquidity needs

Concludes that the recent pattern of increased institutional trading in large blocks of stock call for a high degree of capital liquidity to accommodate such transactions without undue price disturbances.

Balance of payments effects

Warns that the exemption from capital gains tax for nonresident aliens encourages foreign investment in the U.S.; that this could result in American investors taking their capital out by moving their citizenships abroad, particularly as world capital markets become more integrated.

Revenue aspects

Maintains that it is generally held that maximum revenue is achievable at some rate below ordinary income rates because of the postponable nature of capital gains. Concludes that ordinary income treatment of capital gains would require constructive realization at death.

Options for capital gains treatment

Holding period.—Maintains that it is in the long run that inflation has its principal effects on capital gains as well as for the retention of profits. Presumably the historical practice of higher tax on short-term capital gains has been due to their speculative nature, less bunching, less of a gain accrued, more similarity to trading in stock in trade than to investments, purely speculative short-term gains reflect less of a contribution to the economy, and short-term gains are more likely to be spent.

States that the proposal for extension of the holding period and for a shift to a sliding scale inclusion ratio on longer term gains would equitably express the principle that capital gains should be taxed less the longer the assets were held. It would reduce the lock-in for longer term holdings. However, it would also involve a cost in reduction in short-term liquidity if there were a decline in stock turnover, which would tend to depress the level of asset prices and raise capital costs.

Constructive realization at death or carry-forward of basis.—Concludes that a proposal would be a necessary counterpart if capital gains were to be treated as ordinary income, in order to prevent a sharp decline of realizations. Constructive realization should not be retroactive to gains accrued prior to change in law. Applying constructive realization only to future gains, however, would produce small revenue gains initially. This subject has to be coordinated with estate tax changes. Constructive realization at death is not an equitable means of creating greater equality of opportunity—which is the purpose of the estate tax.

Adjustment for inflation.—Maintains that the inflation factor argues for either an inflation adjustment for capital gains or for less severe tax treatment of all gains.

Ordinary income treatment of capital gains.—Concludes that this would decrease the supply of saving, raise the cost of capital, reduce liquidity, increase the lock-in, and undermine the revenue yield unless action were taken to overcome the lock-in effect. The loss offset under ordinary income treatment would be inadequate. If losses were fully deductible from ordinary income, taxpayers could time their realizations of gains and losses to severely damage the revenue. Only accrual taxation of capital gains would help in such a situation.

Accrual taxation.—Avers that accrual taxation, however, would intensify inequities and raise overwhelming administrative problems and be destabilizing in its revenue impacts.

Responses during discussion.—Maintains that if capital gains are to be taxed, then their special characteristics must be considered so that capital gains are separated out as much as possible from the regular income definition—i.e., a change in the value of capital assets is not a very good indicator of better off or worse off and the Haig-Simon definition of income is not very useful. Further, asserts that if capital gains cannot be divided meaningfully into the part that is "income" and that which is not, then the present system should be continued, although it is an arbitrary way.

Suggests that the proposed inflation-factor adjustment for capital gains might have an anti-inflationary effect since the Government would have less tax stake in inflation-generated gains.

Believes that increased capital gains taxation would reduce the amount of savings available for private investment, and that accrual taxation of capital gains could result in intolerable fluctuations in revenues and be countercyclical in the economy.

To encourage capital formation, urges that we do not tax capital gains as ordinary income since this would reduce savings available for investment. Maintains that the investment tax credit does not increase the supply of capital, but only reorients the allocation of investment away from housing and towards the industries that benefit from it. Suggests that another tax measure to increase saving might be to cut the corporate tax rate to leave more for reinvestment; also, feels that any tax that would be taken out of personal consumption and not savings and in turn used by the Government to lend, for example, to housing or other capital uses would increase overall savings.

Maintains that to treat capital gains as ordinary income (even though reducing the top rate to 50 percent) would increase the severity of capital gains taxation, since the top effective rate is slightly above 35 percent now. Feels that revenues will not increase, however, unless the "lock-in" is eliminated.

Indicates that long-term averaging of capital gains would be better than full taxation of gains, with less of a lock-in, but that the revenue impact is unclear. Asserts that it would still have some negative effect on the total flow of savings. To make full taxation of capital gains effective, considers constructive realization of gains at death to be required.

PANEL NO. 3—TAX TREATMENT OF CAPITAL RECOVERY (INVESTMENT CREDIT, ACCELERATED DEPRECIATION, AND AMORTIZATION)

Professor Martin David, University of Wisconsin, Madison, Wisconsin:

Believes that the criteria for a good depreciation system relate to equity, not to investment incentives. Feels that erosion in taxation through excessive depreciation deductions is not desirable. Believes that the 1962 reserve ratio test would prevent excessive depreciation being taken, and without this test, administrative guidelines for depreciable lives are arbitrary. Feels there is no factual basis for the shortening of guideline lives allowed under the Revenue Act of 1971.

States that it is widely accepted that depreciation should reflect the decline in market value of an investment that occurs from physical deterioration and obsolescence. Believes that deviation from this with arbitrary acceleration of depreciation subsidizes industries according to capital output ratio and the pattern through which acceleration was established, and gives increasing subsidies to the growing firm.

The present situation

Considers that the Revenue Act of 1971 and ADR create an arbitrary system of capital recoveries. Feels it is arbitrary because the guideline lives are based on totally inadequate information on the actual service lives of plant and equipment. States that so little is known about actual service lives that industries cannot make comparisons among themselves. Describes the sources of information used to construct the 1962 guideline lives, which are used in the ADR system, and concludes that the information was deficient.

The reserve ratio test

Believes that only the reserve ratio test prevented the 1962 depreciation reform from being a blank check written on the Treasury. Considers the reserve ratio test to be a method of policing excessive depreciation deductions, and of limiting IRS intervention in depreciation accounting. Says that the objections to the reserve ratio test were largely without merit. States that the primary reason for arguing against the test was that it was efficient, and would preclude arbitrary increases in depreciation. Believes that the reserve ratio test was the controlling element of the 1962 depreciation reforms.

Believes that the present system gives taxpayers unreasonable allowances for depreciation. Also believes ADR allows the Treasury to create and extinguish subsidies to industries and firms by defining guideline classes and lives to be used within each class. Further maintains that, under ADR, taxpayer's deductions for depreciation do not relate to their measure of income.

Asserts that an equitable system of depreciation deductions must

tailor the depreciation rate to individual taxpayers. Recommends that Congress legislate a reserve ratio test to control depreciation. Considers that such a test would moot arguments over tax lives, make unimportant the debate over excessive acceleration of depreciation, and make the depreciation system self-policing, eliminating the need for Treasury to monitor service lives of thousands of business activities.

Considers that favorable tax treatment given to investments in advertising, research and development, intangible drilling costs and worker training programs weighs against investment in physical plant and equipment. Recommends Congress define rules for allocating the expense of investment in research and development and advertising to years in which income is produced.

Recommends that sum-of-the-years digits' depreciation be dropped and that tax accounting move toward composite accounts with declining balance depreciation, maintaining adequate control with the reserve ratio test.

Considers the advantage created by accelerated depreciation to be small by comparison with unrealistic lives used for depreciation of many items under the 1962 guideline lives.

Depreciation and tax policy.—Stated during the discussion that depreciation policy should not be used to get at other issues in tax policy. Accordingly, feels that accelerated depreciation should not be used to cut the effective corporate tax rate, that capital recovery policy should not be used to circumvent unwillingness to delegate taxing powers for economic stabilization, and that capital recovery questions should not be used by the Internal Revenue Service as a device to create tax bargaining situations in examining a taxpayer's return.

Investment credits.—Feels that investment credits change the break-even point for investments, and believes that it is appropriate to ask whether the resulting break-even point is reasonable. States that a study shows there is less obsolete equipment in the American economy now than in 1962. Considers an advantage of a variable investment credit to be reduction of pressure on prices as the machine tool industry approaches capacity.

Inflation.—Notes problems caused by inflation regarding depreciation deductions and return on capital investment. Feels that inflation problems exist in every phase of the tax law. Feels that with a constant cost tax accounting system, should not adjust for inflation only one kind of income.

Robert Eisner, Professor of Economics, Northwestern University, Evanston, Illinois (Panel No. 3):

Argues that in a free economy government intervention should be strictly limited. There are many areas such as investment in human capital, perfection of competition, improvement of the distribution of income, and environmental problems and the provision of public goods where government action is necessary. Subsidization of American business by means of a general equipment tax credit or depreciation allowances in excess of true economic depreciation is quite unnecessary. They are neither equitable nor economically efficient. Both contribute to a misallocation of resources and a consequent reduction of economic output and growth, and both contribute to a redistri-

bution of income from working people to property owners and from moderate income Americans to the relatively rich. By unduly reducing the burden for some they must, in long run, if not immediately raise the burden for others.

Accelerated depreciation in general

States that in the 1959 testimony before the Committee on Ways and Means, several points about depreciation and the tax structure were made: (1) higher depreciation allowances in themselves mean lower tax payments; (2) acceleration of depreciation regardless of how means higher depreciation allowance; (3) the effects of any change in depreciation policy are different for the economy as a whole than for any individual firm. Higher depreciation allowances are advocated on the grounds that they encourage investment, promote growth, and help meet the problem of inflation. These results are usually doubtful and variable. What is clear is that they constitute tax reduction.

Points out that since that 1959 testimony, there has been repeated acceleration of depreciation, the 1962 guidelines, the abandonment of the reserve ratio test, and the 1971 asset depreciation range system and other special amortization and depreciation concessions. The total of these extensions and certainly the ADR system have gone far beyond the redress of any claimed imbalance between allowable tax depreciation and true economic depreciation or decline in value of capital over time. The most striking evidence of this is the behavior of the capital markets. Higher after-tax earnings plus higher accounting depreciation charges which make earnings look less resulted in a secular increase in price "earnings" ratios of common stock. Market analysts have focused on cash flow rather than net earnings calculated after arbitrary deductions for depreciation. The fact that firms use lesser depreciation on their books than is allowed for tax purposes because to do otherwise would make earnings appear unduly low is a direct indication that tax depreciation is unduly high. When tax depreciation exceeds economic depreciation, the owners of property are receiving "welfare payments." Such excess deductions are clearly a "tax expenditure" which has the same effect as a direct expenditure.

Asset depreciation range system

Analyzes the effects of ADR as follows: (1) the ADR system will cause permanent revenue losses; it is not merely a postponement of tax payments, (2) the ADR system is unlikely to have much effect on capital investment, (3) to the extent that ADR would stimulate capital investment, there are better ways to accomplish this, (4) ADR discriminates against certain types of investment, (5) balance of payments considerations do not support the ADR system, (6) possible advantages of ADR in public utility area are limited by accounting and rate making restrictions, (7) the ADR system is destabilizing.

Special amortization provisions

Suggests that special amortization provisions regarding rehabilitation and low-income rental housing, pollution control, railroad rolling stock, coal mine safety equipment, on-the-job training, child care facilities and amortization of railroad grading and tunnel bores

should all be treated in terms of the basic principles of equity and resource allocation as indicated above. With regard to items like pollution control and coal mine equipment, it is not clear that the public should pay through tax revenues to induce firms to avoid inflicting costs on the general population or its own workers. Producing units should meet these costs themselves, rather than rely on the general taxpayer. On-the-job training and child care facilities may represent investment in human capital where government help is warranted because of the "externalities" involved. Provisions regarding low-income housing and railroad rolling stock and railroad grading and tunnel bores should be judged on whether there are positive externalities or desirable income redistribution effects and whether these special amortization provisions are the best way to achieve the desired results.

The equipment tax credit

Argues that the so-called investment tax credit is not a general tax credit. It does not apply to plant, only equipment; it applies to investment in equipment by business and therefore excludes vast amounts of investment in physical capital by nonprofit institutions and State, local and Federal Governments. It does not apply to investment in housing or durable goods nor any form of intangible investment such as research and development or investment in human capital. Many of these areas have a higher priority for limited investment funds.

Avers that although new investment in equipment can be expected to increase productivity, where it would raise productivity and prove profitable we should expect that businessmen would undertake it already without a need for a subsidy. It is not clear that the government should subsidize a firm to encourage it to make an investment that is uneconomic and unprofitable otherwise. The prime determinant of business investment is demand. When there is idle capacity, tax subsidies are not likely to encourage investment because although they increase after-tax earnings, they do not make additional equipment profitable in the face of existing idle capacity. On the other hand, where demand is brisk and additional capacity is necessary, firms will invest without special subsidy. During a period of unemployment, subsidizing investment in equipment may be better than doing nothing but there are other approaches which could also increase employment without the undesired changes in the distribution of income which result from general long-run subsidies to big business purchasers of equipment.

A variable equipment credit or subsidy

States that a constant equipment tax credit tends to aggregate cyclical fluctuations. In a boom, the constant tax credit involves a greater reduction in taxes than in a recession when investment is low. It is also a generous gift to businesses which would have purchased equipment in any event. The use of a variable equipment tax credit for countercyclical purposes has considerable potential. Such a credit should have marginal rates much higher than those in the current law but should be concentrated on the stimulus of purchases that would not have taken place without it. It should vary widely in amount with all concerned recognizing that any rate is temporary and likely to vary not only between a large positive number and zero but to a negative number, thus becoming a tax rather than a credit when it becomes necessary to dis-

courage expenditures in order to cool off the economy; for example, there might be a large subsidy, say, 35 to 50 percent of the purchase price for all increases in the purchase of equipment. This could apply not only to business but to nonprofit institutions and to State and local governments. It should, therefore, take the form of a direct payment rather than a tax credit. It would also benefit small unprofitable new firms which have little income tax. "Increases" in purchases would be measured as the excess of dollar expenditures over the average expenditures in, say, the previous three years.

Suggests that some special provision might be made for new or rapidly growing firms to give them full advantage of any possible subsidy and prevent them from being unduly stifled by the equipment tax in inflationary periods. Both accelerated depreciation including ADR and the equipment tax credit are unwarranted loopholes in the income tax structure. They are generally ineffective in stimulating investment but they are effective in redistributing income. The asset depreciation range system should be eliminated and the equipment tax credit eliminated or converted to the marginal and variable subsidy tax on all forms of investment.

Made the following comments during the discussion:

International competitiveness

Maintains that the argument that we have to give special subsidies to American business for what is called capital recovery because foreign governments do it is absurd. If foreign countries want to give a subsidy to our corporations and they are foolish enough to do so, then by all means, take it. Why should we give subsidies out of the hard-earned earnings of our people to provide American companies with similar special privileges that they are able to obtain from foreign governments. The competitive argument is incorrect. We obviously cannot be competitive in everything and if you give a subsidy to one particular company it is not at the expense of foreign companies but at the expense of other American companies. If we have a chronic imbalance of payments, changes in the rate of exchange should be the proper adjustment.

Industrial capacity involves more than the existing stock of plant and equipment particularly if international comparisons are being made. Believes it important to realize the advantages of a free enterprise system compared to systems which try to create prosperity by granting special privileges to particular groups. Therefore, comparing capital recovery allowances in one country with another is not really very significant. For example, does the United Kingdom have a higher standard of living and more productivity than we do? We do have the greatest industrial machine in the world, differences in taxation notwithstanding.

Subsidies for other types of investment

Argues that perhaps there is a justification for providing a government subsidy to invest in training and education since private businesses cannot always recapture the benefits of training their own employees since the employee will not necessarily remain with the training company. This external effect justifies a government subsidy as does the fact that imperfect capital markets prevent an individual

from obtaining the amount of funds for his own training that is economically justified. It is important to realize that increases in productivity can be obtained by investing in research and development and training as well as in equipment.

Concerning the discrimination against business in buying equipment, suggests that consideration should be given to the discrimination against the hiring of labor that results from the 12 percent payroll tax.

Concerning inflation, as long as it is not reducing total output, then it has merely distributional effects, and the last people one would expect to have lost due to inflation are the investors in American business, in contrast to those on fixed salaries or pensions.

Effectiveness of investment incentives

Suggests that, with respect to Dr. Rinfret's observation, the worst way to find out what determines investment and what works is to ask businessmen what the answer is. Obviously, they will say that a tax incentive increases investment.

Argues that the amount of saving is relatively fixed and an incentive to business expenditures for plant and equipment means there will be less capital for investment in other sectors. For example, in the housing area—in part, because of the driving up of interest rates by the increased demand for business investment. We could have as much investment as a proportion of GNP as does Japan if we spent as little on defense expenditures as they did.

Disagrees with Dr. Rinfret's statement that business investment depends on cash flow, it is profit maximizing that determines investment. Given the existence of capital markets, business investment is not dependent on cash flow. The statistical association between cash flow and investment is that during profitable periods when cash flow is high, the profitability of investment is also high.

Effectiveness of investment incentives

Does not believe considerations of growth dictate the departure from equity provided by the investment incentives.

Suggests that on each occasion where the equipment credits seem to be associated with an increase in investment, it is because of increased profit expectations. The initial introduction of the credit was successful because it was part of a general effort to stimulate the economy. Concerning the on-again, off-again character, suggests that the evidence is that there is more potency to this plan than to a permanent credit, as evidenced by the 1966 suspension and 1967 restoration. It is clear that business can time its investment to some extent although the long-run demand for capital is not dependent on tax incentives. The experience of 1971 is very instructive. Business did not respond quickly to the reintroduction of the credit and responded only as the state of the economy improved.

Believes monetary and fiscal policy generally were more effective in stimulating investment than was the investment credit. Concerning monetary policy, disagrees with Dr. Rinfret's comment that removal of the equipment credit would drive up interest rates because corporations would be forced to borrow in the money markets. This ignores the fact, that the $3 billion revenue loss means that the Federal Government itself has to borrow $3 billion in these same

markets so that it would have approximately the same effect on interest rates.

In response to a question asking if there is a low use of the equipment credit when the demand for goods is low, and vice versa, states that the prime determinant of business investment is the relationship between demand and capacity. Does not believe that the corporate profits tax, in conjunction with the capital gains tax we have, actually discourages investment. What we do have is a lot of conversion of ordinary income to capital gains. There is a huge incentive for wealthy individuals in high tax brackets to invest in companies that have tax advantages that enable them to acquire equipment to take the appreciation in value represented by that equipment in the form of capital gains.

Relative impact of different incentives

Believes that removal of ADR would have a somewhat lesser immediate impact dollar for dollar than the removal of the investment credit but the economy would be slowed up by removal of either of these simply because that would represent an increase in taxes. If one removes these concessions, one is raising taxes. Suggests that the appropriate question to ask is how would the economy be affected if we removed ADR (at about a $3 billion annual revenue loss) and substituted, for example, a reduction in payroll taxes on teenage workers. The net of this would probably be of benefit to the economy rather than harm. It is important to keep in view that the proper way to put the question is always in terms of alternative uses of revenue rather than just the elimination or addition of a particular provision. The important point to remember is that removing a tax concession is going to cost somebody something, in this case, even small business. The relevant question is that if we remove these tax concessions which are worth roughly $8 billion and substitute something else of equivalent cost, will small business be better off or worse off. We must recognize that every tax concession is in effect, a tax on someone else. Unless we approach the tax program that way, we are misleading ourselves. Obviously, any tax concession will help business to some extent if you ignore the fact that the counterpart of the tax concessions is higher taxes for somebody else.

In response to a question about the effect of an across-the-board tax reduction for business compared to the investment credit and ADR as far as new investment is concerned, states that it would probably tend to reduce slightly the purchase of plant and equipment by business and increase other forms of investment in research and development, housing and human capital. It would make the tax structure more neutral.

In response to a question about the choice between eliminating the investment credit and ADR, prefers removing ADR in the interest of openness. Considers them both a subsidy to businesses who acquire plant or equipment and thinks it important to keep these subsidies open. The public cannot understand the way they are presently structured, particularly ADR. Moreover, tax depreciation should be as close as we can make it to economic depreciation. We have moved tax depreciation far beyond true depreciation as evidenced by industry accounting practices and financial measures.

Incremental credit

Suggests that if we really believe we want an equipment credit to stimulate investment, there is no good reason why we should not have an incremental credit. What we have now is a $3 billion a year revenue loss in very large part from investment that would be undertaken in any event. For the same $3 billion we could get a much greater bang for our buck by not giving the investment credit for investment that would not otherwise be undertaken. All one has to do is look at depreciation allowances in determining what is incremental and this would not be a particularly troublesome complication.

C. Lowell Harriss, Professor of Economics, Columbia University, New York, N.Y. (Panel No. 3):

Believes that high levels of capital investment will lead to more jobs and more business productivity, which in turn will lead to a higher general standard of living. Believes that tax policy should take account of the substantial need for capital and that high taxation of business earnings will have undesirable nonrevenue effects. States that corporate or other business taxes ultimately fall on people, just as individual income taxes do, but believes that this point is often ignored because there is a prejudice against businesses.

States that tax policy with respect to corporate recovery should take account of the inflation factor in our economy. In a period of inflation, the historical cost of equipment is not an adequate measure of the cost of replacement. Accelerated depreciation (including ADR) and the investment credit are desirable because they do help businesses to meet the problem of inflation. Even if the problem of inflation were somehow to be cured, these rapid capital recovery devices would still be needed to make up for inflation which has already occurred. If there were a period of prolonged economic stability, however, a gradual reduction in the tax on business earnings would be desirable.

Capital should be favored

Cites two strong policy reasons for biasing the tax laws in favor of capital formations. First, capital formation is needed to create the productive facilities which today's young people will need when they mature. Secondly, a high rate of capital investment will speed the benefits of new technology into the economy.

Indicates that he favors a general reduction in the corporate tax rate but was uncertain whether such a reduction would have a greater impact on investment than the investment credit. States that fast depreciation, including ADR, should not be viewed as being in lieu of a tax reduction for business, because these devices are ways to create a measure of net business income, and adjust for the impact of inflation. The investment credit, on the other hand, does operate as a tax reduction device, although it also serves to help offset inflation.

John S. Nolan, attorney, Miller & Chevalier, Washington, D.C. (Panel No. 3):

Need to continue present tax provisions

States that the investment credit, accelerated tax depreciation (particularly the ADR system), and the special 5-year amortization provisions of the Internal Revenue Code are varying methods of encourag-

ing a higher level of investment in capital goods to improve our economic health and advocates that they should be retained as permanent elements of our tax structure. Believes that these capitatl recovery items have achieved a reasonably satisfactory adjustment for the major disincentives to investment inherent in our income tax system and should be retained to sustain a continuing high level of investment in machinery and equipment based on certainty as to business tax liabilities. Points out the inequities, complexities, and administrative difficulties in the use of the investment credit as a counter-cyclical device by its repeal and reenactment in the past and suggests that this should be discontinued and that the investment credit should be made permanent. Suggests that the ADR system should be retained without a reduction in the 20-percent variance since it provides substantial administrative advantages which will be lost if the variance is reduced. Supports the use of the special 5-year amortization provisions in limited circumstances as a useful function for a specific area of investment needs but believes that even in these cases the amortization provisions should automatically terminate to allow Congress to reenact them on a showing that they proved effective by cost benefit analysis.

Need for special capital recovery provisions

Points out that the high Federal corporate income tax (48 percent) plus State corporate taxes (ranging up to 9 percent in some cases) requires special provisions to encourage investment. Believes that these high rates provide disincentive effects to our tax system and that since most investment in plant and equipment in the United States is accomplished by corporations, this will be continued only if the after-tax rate of return makes it more profitable than other forms of investment. Points out that the investment credit and accelerated depreciation stimulate investment in machinery and equipment and thus speeds the process by which the newest technology is incorporated into productive facilities. Points out that by encouraging business investment in all machinery and equipment the cost recovery provisions operate broadly to raise the level and efficiency of our national production.

Effectiveness of capital recovery provisions

Points out that the capital recovery tax provisions that have been granted are an effective way of dealing with problems of unsatisfactory performance by the economy. Points out that the statistics indicate that since the investment credit and ADR provisions were enacted in the Revenue Act of 1971 the United States has witnessed a very extraordinary change in conditions since mid-1971. Indicates that the sharp business upturn following their enactment speaks for retaining the investment credit and ADR as a permanent feature of our tax system.

Problem of international competition

Points out the competitive situation U.S. producers are engaged in with foreign producers in world markets. Points out that even with the reinstitution of the investment credit and the present ADR system, the United States provides substantially less incentive in its in-

come tax laws in investment in machinery and equipment than the United Kingdom, Japan, West Germany, Sweden, and Belgium. Believes that unless investment credit and ADR are retained without change the competitive pressures on U.S. producers will be increased as foreign producers benefit from even greater tax concessions to the extent they invest in new plants and equipment which would narrow our productivity advantage.

Administrative advantages of ADR

Points out that the ADR system is elective rather than mandatory and that the 20-percent variance is an incentive to elect the ADR system. States that it provides simplification and certainty to business taxation; however, as a condition to realizing the advantages of the ADR system, taxpayers must give up some of the flexibilty and options they would otherwise enjoy and in effect pay ordinary income tax on certain gains that would otherwise be long-term capital gains. Lists the major administrative advantages to the ADR system both to taxpayers and the government as follows:

(1) Requires the election by taxpayers for each year in which assets are acquired designating the life which will be used within a range 20-percent shorter to 20-percent longer than guideline class life for such assets (which cannot be changed either by the taxpayer or the Internal Revenue Service), which will eliminate the disputes over the useful life of particular assets.

(2) Requires the taxpayer to specify the salvage value taken into account in determining the annual depreciation amount and provides that the salvage value cannot be changed either by the taxpayer or the IRS unless the IRS proves an increase of more than 10 percent of the cost of the asset over the taxpayer's amount of salvage value in which case the entire amount of the increase is made.

(3) Provides a repair allowance for determining whether an expenditure is a capital expenditure or a current expense item (unless it is clearly a capital expenditure) by allowing the deduction of a specified percentage of the asset account and requiring the capitalization of the excess.

(4) Defers the recognition of gain and loss of retirements of particular assets in an asset account until the account is fully depreciated or the account is closed. This change causes gains on assets to reduce depreciation deductions rather than being treated as capital gains and generally simplifies depreciation accounting.

(5) Allows certain regulated utilities to use ADR only if they normalize the tax savings, consistent with the treatment provided for accelerated depreciation methods in the Tax Reform Act of 1969 for these utilities. This will reduce disputes with State regulatory commissions and will insure that the ADR system serves its intended investment incentives in effect for these utilities.

(6) Requires taxpayers electing ADR to group their assets into "vintage accounts" and provide information as to acquisitions and retirements of assets by these accounts each year with their tax return. This will allow the Internal Revenue Service to collect data on asset acquisitions and actual useful lives of assets from experience.

Special amortization provisions

Points out that the amortization provisions have been criticized as tax expenditures which escape the annual appropriations review in Congress. Suggest that the automatic 5-year termination of these provisions insures that Congress will periodically review the effect of these provisions. Believes that with this safeguard there is no reason to have a direct subsidy approach rather than this tax expenditure approach.

Relative impact of investment credit and use of ADR

States during discussion that in quantative terms the investment credit has a much greater impact upon investment than would the ADR system. Reiterates that the ADR system has major administrative advantages but is aware that it has not been widely adopted yet. Believes that it will be adopted by more companies in the future since there were reasons that fewer companies have adopted it so far. Points out that part of the problem was in the long delay in issuing regulations which implemented it and that businessmen wanted to see how it actually operates before they allowed the system.

Pierre Rinfret, Rinfret-Boston Associates, Inc., New York, N.Y. (Panel No. 3):

Need for faster capital recovery

Supports investment credit and ADR; believes credit is inadequate in internationally competitive terms and should be raised to 10 percent. Special small business investment credit greater than 7 percent is needed.

Points out that the rest of the world provides quicker and easier capital recovery than United States. Worldwide mobility of capital is so great that it can go anywhere in the world. Worldwide demand for capital is growing so rapidly that the supply will be inadequate, and the United States must take steps now with respect to capital recovery to protect its demand for capital. With inadequate incentives in United States, capital will flow rapidly elsewhere in the world. United States has lowest ratio of investment in new plant and equipment to level of total production in industrial countries.

Cash flow.—Investment expenditures are linked to cash flow which can be increased or decreased by the investment credit. Further cites 1969, 1970, and 1971 because of coincidence of loss of investment credit, reduced cash flow and no increment to real investment.

Foreign countries may not have investment credits, but do have a variety of provisions that speed the recapture of the capital investment. Furthermore, contends that the outflow of U.S. capital is associated with its slower rates of capital recovery.

Believes that repeal of either the investment credit or ADR will force some companies into the capital market for those funds, tightening the money markets, and other investors will send their capital to other countries where they can rely upon stable tax provisions.

Japanese corporations are highly leveraged—about 10 percent equity and 90 percent borrowing from the central bank. It is two-thirds and one-third, respectively, in the United States.

Presents calculations on depreciation recapture for different nations

which were not carried out to an estimate of income tax payments (in supporting evidence for oral statement).

Corporate tax rates and tax incentives.—Does not recommend two-tier corporation income tax because it places a higher tax on retained earnings. Adaptation of the Swedish reserve system to the United States would be preferable to repeated repeal and restoration of the investment credit.

Does not expect adoption of a better, more neutral tax system in which taxes are lower, tax structure is simpler, and the cash flows to the stockholders who make their own reinvestment decisions. It would produce a more equitable and efficient allocation of resources.

Prefers to retain the investment credit than provide an equivalent reduction in the corporation income tax because he is "not sure private enterprise would do the right thing with that tax reduction." Fears that some of the tax reduction would be used for an increased dividend payout rather than increased investment.

Production capacity and full employment criteria.—Inadequate production capacity problems do not exist in many U.S. industries, such as, electronics, shoes, textiles; the capacity problem in textiles is insufficient trained persons to run the facilities. But other industries, such as, paper and auto manufacturing are operating above their rated capacity levels. An adequate supply of physical facilities for human beings to run efficiently is needed.

Full employment is not described by a percentage rate of unemployment. It is reached in this country when every man, woman and child wanting work is at work—wherever they may be located in the country.

Production capacity by industry is determined in terms of normal weekly operations patterns. Continuous process industries like basic steel work round the clock, 7 days a week, as normal operations.

Capital outflow.—The reasons for the capital outflow are complex, and many years of study may be necessary to understand it completely. The speed of capital recovery is an important variable in the decision. A large share of American investment abroad is made in countries with a speedy capital recovery. International competition is so intense that small differences in the rate of return—in decimal points—can affect the decision where to invest and can be affected by tax incentives.

Repeal of the investment credit forced business firms into the capital markets, tightening them and forcing up interest rates as high as 9.36 percent (in June 1970). By the fall of 1970, there was a recession with unemployment at 6 percent and even higher rates in the capital goods industries.

Offers as reasons for capital outflow from U.S.: (1) poorer rate of economic growth than in European common market; (2) laws abroad more favorable to capital than in United States; (3) specific cash benefits and subsidies unmatched in United States; (4) unstable value of dollar on foreign exchange rates; and (5) the continuation of balance-of-payments deficits.

National well-being.—There is too great a tendency in this country to be complacent because of our past position and to overlook current trends and growth rates which show us at a disadvantage. The rate of

growth in the United States has been inadequate relative to the rest of the world's industrial nations. United States has lost its competitive edge because other countries have become more capitalistic in use of resources.

The United States standard of living is lower than the Swedish standard of living, and by 1980, the French standard of living—given continuation of present growth rates—may be the second or third highest in the world.

PANEL NO. 4—TAX TREATMENT OF REAL ESTATE

Alan Aronsohn, attorney, Robinson, Silverman, Pearce, Aronsohn, Sand & Berman, New York, N.Y.:

General comments

States that the imposition of additional adverse tax changes upon the real estate industry might well stifle risk-taking and capital mobility in an industry which depends upon maximum investment from the private sector. Suggests that if any revisions in our tax laws are appropriate, they should be applied across the board to all taxpayers rather than being limited to the real estate industry.

Depreciation

Testifies that the depreciation deduction as applied to real estate does not represent a tax incentive or tax abuse in favor of owners of buildings, but merely allows recovery of original capital costs over an estimated useful life. States that the accelerated depreciation deduction is perfectly sound for the following reasons: (1) the earning power of a building, in relation to its economic useful life, is usually greater when it is new than as it grows older; (2) a denial of accelerated depreciation of real estate investments discriminates in favor of personal property investments and against those in real property, in the competitive market for capital; (3) denial of accelerated depreciation reduces effective rates of return on unrecovered investment, thereby resulting in higher rents to tenants and increased inflation; and (4) accelerated depreciation is a pragmatic counter-balance to the extraordinary long guideline lives currently specified by the Internal Revenue Service for buildings and building components.

Opposes the proposal to limit the depreciable basis in real estate to a taxpayer's equity interest. Comments that it is inequitable for the tax consequences of the ownership of an asset to be dependent upon the method of financing its purchase or upon whether it is rental real estate, user real estate, or personal property. States that this proposal would permit taxpayers to defer depreciation until desired by deferring the repayment of the mortgage loan. Feels that if borrowing is bad, the whole system, not just the real estate industry, should be revised to treat borrowing alike.

Low income housing

States that Congress should review the tax incentives provided for rehabilitation expenditures and low-income housing and decide if the social goals achieved by these incentives outweigh the tax results stemming from them. Testifies that he is not ready to accept the statement that direct Government programs are more efficient.

Non-recourse loans

Suggests that Congress review the nonrecourse loan. Feels that it exceeds the realistic value of the property and is created primarily for tax purposes without any reasonable prospect of repayment.

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Construction period

Testifies that interest and real estate taxes paid during the construction period should be allowed as a deduction and to require capitalization of these items would discriminate against taxpayers who must borrow and those who need not borrow. States that, in addition, it would discriminate against the real estate industry in favor of other industries where, for example, a corporation constructs its own plant or manufactures its own tools. Feels that the mandatory capitalization of interest and real estate taxes during construction would substantially accelerate a movement of the real estate business from individual ownership to concentration in the hands of a limited number of major corporations.

Limit on losses

Opposes any proposal which would limit tax losses incurred with respect to real estate to the income actually derived from it.

Adrian W. DeWind, attorney, Paul, Weiss, Rifkind, Wharton & Garrison, New York, N.Y. (Panel No. 4):

Tax shelters

States that attractions of real estate tax shelters are very significant for taxpayers with marginal tax rates greater than 50 percent. Describes the three basic elements of tax shelter in rental real estate.

1. *Construction period deductions.*—Says that deductible taxes, debt interest, and other expenses paid during construction reduce taxable income from other sources. States that with a highly leveraged investment, this may account for all the equity by the time construction is completed. Believes that a 60 percent recovery of investment through tax deductions, by the end of construction, is typical. Says general accounting practice requires these costs to be capitalized.

2. *Accelerated depreciation.*—Says that accelerated depreciation is allowable not only for the cost of the taxpayer's equity, but also for costs financed through mortgage debt. Asserts that accelerated depreciation rapidly produces tax savings that exceed equity remaining after construction.

3. *Conversion to capital gains.*—Says that depreciation deductions, which the taxpayer may use to reduce his ordinary income from other sources or to obtain operating loss carryovers, may be "converted" into capital gain upon a sale or other disposition of the real estate.

Leverage

Maintains that real estate investments are often highly leveraged with nonrecourse debt, and that construction expense deductions and accelerated depreciation further leverage the taxpayer's return on the property. Asserts that taxpayers in marginal tax brackets of 60 percent or more often recover equity investment within two or three years after construction.

Deferral

Believes that construction period deductions and depreciation, even straight-line depreciation, allow tax write-offs in excess of any economic loss of value. Maintains that this is evidenced by debt amortization payments that are smaller than depreciation. States that these deductions have the effect of deferring taxes until a sale or other dis-

posal of the realty. Believes that tax deferral is equivalent to a long-term, interest-free Government loan (or subsidy) to the taxpayer. Also believes that tax deferral is the largest value in the tax shelter for most investors.

Refinancing

Says that often a mortgage debt may be refinanced after 10 or 12 years following completion of construction. Believes that where the amount received is greater than tax basis, there is an economic gain, and consequently another tax deferral.

Need for tax subsidies

Believes that these tax subsidies may be needed for low- and middle-income housing. Maintains that other construction, including commercial and industrial, has a real economic rate of return that makes a Government tax subsidy unnecessary.

Recommendations

If a decision is made to reduce tax shelters, recommends that depreciation allowances should not exceed straight-line depreciation taken over a reasonable useful life of the structure. Also recommends a full recapture of depreciation at ordinary income tax rates, to the extent the amount received exceeds basis upon a sale or other disposition of real estate. Further recommends limiting depreciation to taxpayer's equity, with an unlimited carryover of unused depreciation to be deducted as equity increases through amortization of the mortgage debt.

Recommends capitalization of expenses incurred during construction. Additionally recommends that amounts realized through debt refinancing should be treated as realized gain to the extent the amount of refinancing exceeds the tax basis of the property, with an appropriate increase in the basis for depreciation.

Responds to inquiries as follows:

Asserts that the professional real estate investor only sells the tax benefits to nonprofessional investors when they reach a level in excess of what he can use to offset taxable income. Comments that, under present tax pattern, realty yields only tend to diminish after about 14 years, but that cash flow may be preserved from tax by switching savings into new real estate projects.

Suggests that lower mortgage amortization rates as compared with depreciation rates prove that rental realty depreciation allows tax write-offs in excess of real diminution of value.

Notes that to remove real estate tax shelter except as part of a plan dealing with all tax shelters may only reallocate tax discrimination. Proposes that depreciation of commercial structures and of high-cost rental realty should be the same. Believes that inflation in land values is caused by current tax treatment and might disappear if that treatment were changed.

Proposes that taxing capital gains at death would free and increase flow of capital investment. Favors a more broadly based tax, with increased and adequate averaging, at a top tax rate of about 48 percent.

Jerome Kurtz, attorney, Wolf, Block, Shor & Solis-Cohen, Philadelphia, Pa. (Panel No. 4):

Analyzes the real estate tax shelter through a typical housing development under section 236, Housing and Urban Development Act of

1968. Concludes that the overwhelming portion of the return earned by an investor comes from the tax system through excessive depreciation deductions, lack of recapture, and current deductibility of certain capital costs. Also concludes providing rewards through the tax system is uneconomical and results in poor housing and tax policies.

An illustrative section 236 project

Sets forth illustrative section 236 (limited partnership) apartment project. Under stated assumptions, projects taxable loss for each of the first 19 years of the investment, with a cumulative taxable loss in that period of over $5 million for the limited partnership. For the same period, projects cash flow available for distribution to the partners to be over $59,000 per year except for the first two years. For an individual partner with a $50,000 investment, projects taxable losses of $173,997 over the holding period (21 years, 7 months), and cash receipts of $40,280 during the same period. For a limited partner in a 50-percent tax bracket, projects cumulative after-tax cash benefits of $127,282 (and a rate of return on investment after taxes of 20.2 percent). For a 60 percent tax bracket limited partner, projects after tax cash benefits of $144,678 (and a rate of return of 27.5 percent). (The projected rates of return take into account capital gains tax on disposition of the project.)

Description of tax benefits

Maintains that the section 236 project includes two assets—(1) an apartment project with a limited cash return and (2) a stream of tax benefits. Also points out that the principal reason for the projection of both positive cash flow and tax losses from the illustrative project is the tax deduction for depreciation, which does not represent cash outflow. Points out that a tax loss may be used to offset income from other sources.

Syndication

Notes that a section 236 project frequently is not viewed in the market as a real estate investment but rather as a purchase of tax losses. States that these tax losses usually are sold in the market through limited partnership entities. Says that normally a partner may take aggregate losses only to the extent that he has some risk of actually sustaining these losses. Points out that under regulations § 1.752–1(e) limited partners may increase their basis for determining losses by their proportionate interest in liabilities as to which no partner is liable, and states that this is the case in section 236 developments.

Leverage

Considers that a large mortgage is crucial to a tax shelter, and that rates of return will not increase substantially with increased depreciation deductions without high leveraging. Asserts that the combination of high leverage, accelerated depreciation, limited partnership, and the rules on no-liability mortgages form the basic structure that is known as a real estate tax shelter.

Deduction of capital costs

Believes that additional tax benefits come from allowing current tax deductions for costs during construction that are capitalized for ac-

counting purposes. Points out that these items include interest and fees regarding the construction mortgage and real estate taxes during development. Says these items are primarily responsible for substantial tax losses permitted during the early stages when a project is under construction.

Consequences of the tax incentives

Maintains that costs incurred in marketing a section 236 venture are wasted resources. Additionally, maintains that since tax benefits do not correspond to risk undertaken or priority of need, the government is not receiving the riskier and highest priority housing developments for its tax cost. Feels that tax rules currently distort the distribution of income tax burden, excusing from tax some of the wealthiest individuals.

Recommended changes

Recommends limiting depreciation deductions to straight-line depreciation, although believes that straight-line gives a considerable subsidy to most real estate. Also recommends that the recapture rules for real estate should be the same as for personal property under section 1245, because believes that depreciation is excessive if the property is sold for more than its depreciated basis. Additionally recommends that the effect of leveraging be reduced either by treating equity investment as the basis for depreciation, or by permitting depreciation with reference to the entire property, but limiting aggregate losses to cash investment. Further recommends that mortgaging of property in excess of basis produce income at the time of the loan (adding this element to basis). Would not differentiate between mortgages with and without personal liability for limiting depreciation deductions, because believes there is little or no economic difference between the two situations.

Other than § 236 development

Asserts that wasteful, inefficient, and misdirected tax treatment exists in a section 236 housing project, and is even more severe in nonsubsidized housing and commercial real estate, where there should be no government subsidies through the tax system.

Responds to inquiries as follows:

Agrees that real estate is an extremely risky investment. Questions whether return for risk should come from the tax system and tax shelters. Says the prime risk with section 236 projects is early foreclosure, ending tax deferral.

Believes that changing section 236 projects to a direct subsidy program would not be difficult, and believes that all administrative details needed for direct subsidy are worked out under the current program.

Would distinguish industrial real estate built to house a new factory from rental real estate; believes different incentives may be involved with industrial real estate.

Wallace R. Woodbury, attorney, Woodbury, Wunderli & Sorenson, Salt Lake City, Utah (Panel No. 4):

Nature of the real estate industry

States that the real estate industry is largely unstructured, highly competitive, and involves large investments for long time periods. Be-

lieves the industry should receive returns commensurate with its risks and competition.

States that the industry is vulnerable to many types of government control. Believes that the income tax system is important in long-term planning in real estate, and it would be undesirable to impose uncertainty on the industry by making it unable to rely on existing tax laws. Says that tax "devices" that receive publicity represent activities of only a handful of persons and not the usual industry situation.

Erroneous assumptions about the real estate industry

Troubled by erroneous assumptions that underly suggestions for changes in tax laws applicable to real estate, such as, that everyone makes money in real estate. Notes that studies that show unusual benefits received by the industry usually are based on assumptions not consistent with the "real-life" world. Maintains that tax laws are not of more benefit to real estate than other industries.

Considers that real property improvements are wasting assets and owners are entitled to recover the cost used up each year. Recommends no restrictions on depreciation based on how the investor obtains funds to pay for the project. Feels that gain on sale represents appreciation in that part of the project not used up at the time of the sale, and recommends this gain be taxed at capital gain rates. States that cost of borrowing money should be a current deduction since borrowing allows production of income.

Feels that much of the attack on the industry is based on highly unusual programs that interest sophisticated tax specialists. States that these situations may represent an abuse of the tax laws, but are soon corrected by the marketplace or by the Commissioner of Internal Revenue using existing law.

The plight of real estate today

Contends that it would be an error to shift the relative impact of Federal taxation to further impair the competitive position of real estate. Notes that real estate investment is essential to the economy. States that in 1972 multi-family residential housing construction was $16.9 billion; commercial construction was $13.5 billion; and 3.5 million people were employed in construction.

Maintains that 1969 and 1971 tax changes unfairly shifted the burden of taxation to real estate. Points out changes in accelerated depreciation and recapture rules, minimum tax, and limitation on deductibility of investment interest. Says primary effect of these changes was on real estate, not affecting tax-exempt bond interest, intangible drilling costs, farm losses, and charitable gifts of appreciated long-term capital gain property. Considers that 1969 and 1971 changes most heavily affected the small investor and not the more affluent corporations and individuals. Recommends the repeal of the limit on deductibility of investment interest.

Considers risk and complexity to be greater in real estate management and investment than in other major industries. Describes problems in real estate development, including substantial carrying costs for undeveloped land before construction begins, changes in interest rates, risks of construction caused by problems with material, strikes, regulations and other factors, problems with locations and catastro-

phes. Maintains that the unpredictability of tax laws (as evidenced by proposals in 1962, 1964, 1966, 1969, and 1971) adds a serious risk to real estate by increasing instability and unreliability.

Considers the present tax system to be very progressive and that further shifts would be discriminatory and counterproductive.

Believes that all income be reported, including bond interest. Also believes that public confidence in the tax system would increase if reporting distortion were eliminated so that, in determining adjusted gross income, individuals, as businesses, could first deduct expenses of producing that income.

In response to inquiries, comments as follows:

Depreciation.—Believes that accelerated depreciation on real property helps ameliorate the distortion between taxation of real property and personal property that exists because of unrealistic guideline lives for depreciation of personal property. Maintains that, for real property, the excess of selling price over depreciated basis is due to an increase in land value.

Feels that depreciation should be based on cost of property, and should not be related to the method of financing. Asserts that if depreciation is related to financing (mortgage amortization), the small investor will suffer. Additionally, feels that mortgage size is not a reflection of the value of the property, since a lender may rely on factors other than the value of the real estate. Further, believes that improvements may depreciate faster than a mortgage is amortized.

Interest.—Convinced there is no justification for suggesting that interest paid during construction is different from any other interest.

Direct subsidies.—Believes direct subsidies involve administrative problems. Feels that with opportunities built-in to the tax system, people can initiate activities on their own, being able to offset much of the cost they incur.

PANEL NO. 5—FARM OPERATIONS

Charles Davenport, Professor of Law, University of California at Davis, Calif.:

Present farm tax accounting rules

Deviations from good accounting.—States that two principal deviations from good accounting practices were granted to farmers as administrative dispensations when the majority of the people were rural residents. These deviations were the permission (1) to use the cash method of accounting (including the right to ignore inventories) and (2) to deduct expenses during the so-called development phase of a ranch or farm.

Inventories and development costs.—States that accepted principles of accounting prescribe that income is matched against the expense of producing it. Farmers have been permitted to ignore their inventory of crops, feed, and supplies on hand and claim deductions for their cost in the year in which payment is made even though the goods produce no income in that year. Believes that as a result of this practice, a farmer is allowed a premature deduction of the cost of inventories. A premature deduction also arises when the taxpayer elects to deduct the cost of developing an asset. This is particularly obvious in the areas of fruit and nut trees and with the raising of livestock, for examples.

Consequences.—Believes that the allowance of this premature deduction prior to income realization understates the net income in the year of deduction. If the farm does not produce net income equal to the amount of the premature deduction or if there is not any other net farm income, there will be a "farm tax loss" which normally does not represent an economic loss because the value of the asset produced by the premature deduction is as great as the amount of the premature deduction.

Analysis of the benefits.—Believes that three benefits arise as a result of the deviations from general accounting principles: (1) the *deferral* benefit is a consequence of writing off deductions in a taxable year prior to the inclusion of income; (2) the *exemption* benefit comes about when the deduction is matched against long-term capital gain income. (By allowing the expense treatment, rather than requiring capitalization, a portion of the long-term capital gain equal to one-half of the non-capitalized expense is exempted from tax); (3) the *negative tax* benefit arises when the income produced by deduction of the capital expenditure is taxed at a lesser rate than the income from which the capital expenditure was deducted. States that these benefits may be found in a number of different types of farms, including breeding cattle, feeding cattle, and fruit and nut trees and vines.

States that the tax benefits available to taxpayers because of the deviations from general accounting principles are distributed inversely to

the need for them—the greater the income, the greater the assistance from the Federal Government in the form of tax benefits.

The 1969 amendments

The excess deduction account.—Although one entire subtitle of the 1969 Act was devoted to farm losses, submits that the Act was not sufficient to handle the problems. States that legislation which requires recapture, as in the case of the excess deductions account, is ineffective because it does not address itself to the source of the problems which is the basic accounting rules for farm operations. Current deductions can continue and recapture is not activated unless and until there is a sale of assets. Suggests that the careful investor will avoid EDA by limiting his investment so as to produce a loss of $25,000 or less annually. Believes that another major deficiency is that the entire concept of recapture is inappropriate where the name of the game is deferral.

Capitalization of almond and citrus costs.—Believes that capitalization of almond and citrus grove development costs have been very effective. Major objections are that (1) it is much too narrow, (2) the period for capitalization should be tailored to the preproductive period rather than a uniform 4 years, and (3) the exceptions for certain replanting should be abolished.

The proper alternative

Full cost capitalization and denial of cash accounting.—States that the claim that accounting techniques are not available and that they are too sophisticated for the average farmer just does not accord with changes which have occurred since 1913 when our society was largely rural. Urges that full cost capitalization and denial of cash accounting be adopted as correct solutions to the farm problem. Additionally, because of the ambiguity which exists regarding the purpose for which some farm assets are held, for breeding purposes or for sale to customers in the course of business, a holding period of not less than 2 years after the first use should be adopted for all animals in order to qualify for sec. 1231 treatment.

Farm loss limitation

The Corman solution and the Senate Finance version in 1969.—States that two alternative solutions to the farm loss problem have been (1) a limitation upon the amount of farm loss that any nonfarmer could claim unless the nonfarmer was willing to elect proper accounting procedures and (2) a specific limitation on the amount of deductible farm loss in excess of $25,000 incurred by taxpayers having nonfarm adjusted gross income in excess of $50,000 equal to the sum of ordinary income from farming plus one-half of the deductions in excess of that amount with unlimited carryover provisions.

Evaluation.—Concludes that regarding the first alternative solution represents an improvement but does not eliminate the deferral, exemption and negative tax benefits because it will only limit these benefits. The second alternative solution continues deferral on a limited basis and the exemption and negative tax benefits are eliminated as to those persons subject to that approach. Proposes that the ideal solution is full cost capitalization and denial of cash accounting.

Roland L. Hjorth, Professor of Law University of Washington, Seattle, Wash. (Panel No. 5):

Points out that many of the expenses of carrying on a farming or ranching activity are deductible from current ordinary income and when these same expenses are recovered they are taxed as long-term capital gains. Tax benefits are incidental to the main concern of the full-time farmer; however, to the farm investor tax benefits may be the dominant factor.

Deductibility of farm expenses.—States that the problem of hobby farmers is a challenging problem and present law has not been successful in denying deductions claimed by this group. Believes that to the extent that this occurs, the government is bearing part of the cost of what is basically a consumption expense.

Recovering deductions as capital gains.—Suggests that the principal area to which Congress should address itself is the device that might be called the capital gain recovery of a farm expense deduction. Recommends that this device ought to be abolished either by requiring the capitalization of certain presently deductible costs or by applying recapture provisions similar to those contained in section 1245 of the Internal Revenue Code. Believes that this device is inequitable because it subjects small full-time farmers to unfair competition from wealthy farmers and from off-the-farm investors.

States that the Tax Reform Act of 1969 attempted to deal with some of these problems. Certain expenses of raising citrus and almond groves must be capitalized but other trees and vines have been left untouched. Believes that the recapture theory of section 1245 has been applied in the excess deductions account of section 1251 but that section is encumbered by exceptions and limitations.

Current laws authorize graduated subsidies.—Avers that a taxpayer has received a subsidy when he is taxed at long-term capital gain rates on the recovery of an expense previously deducted from ordinary income. This subsidy is a graduated subsidy in that it benefits high-bracket taxpayers more than persons in low tax brackets. The person in the higher tax bracket, therefore, receives a larger subsidy than persons in low tax brackets and this subjects low-bracket taxpayers to unfair competition. Believes that it is doubtful whether this subsidy keeps food prices down if it drives full-time farmers out of business.

The graduated subsidy subjects many farmers to unfair competition.—States that a tax system that gives larger benefits to taxpayers with higher incomes than to taxpayers with low incomes breeds unfair competition. High-income, full-time farmers receive benefits that are unavailable to low-income farmers.

The problem areas.—States that two categories of products present the areas where the tax subsidy applies—(1) cattle and horses held for two or more years, and (2) other animals held for a year or more and held for draft, breeding, dairy, or sporting purposes, and trees and vines which take more than a year to bring to maturity and which have a life of several years.

Amendment of section 1251.—Believes that section 1251 has been relatively ineffective because of the ease with which investors can avoid the $25,000 base prior to establishing an excess deductions account. Additionally, the expenses are still currently deductible. Prefers to

reduce the $25,000 annual exclusion and reduce the nonfarm income requirement to $15,000. Additionally, there would be no objection to eliminating the nonfarm income requirement entirely.

Alternative solution.—Suggests that as an alternative to amending section 1251, one possible solution would be to exclude all livestock from the category of section 1231 and capital assets.

Trees and vines—capitalization of costs.—States that the Tax Reform Act of 1969, through the addition of section 278, dealt with capitalization of certain costs incurred by owners of citrus and almond groves. Believes that if section 278 is to be retained, its application should not be so limited.

Suggests that if section 278 is to be amended, three questions should be answered: (1) To what plants should the statute apply? (2) If capitalization of expenses is a correct method, what costs, if any, should be currently deductible? and (3) Is capitalization of expenses a correct method?

To what plants should the statute apply.—Recommends that the statute should apply to all perennial plants, the existence of which disregarding the produce of such plants, materially enhances the value of the land to which they are attached.

What costs should be capitalized.—Recommends that the period during which capitalization should be required should be the period beginning with the time of planting and ending with the year in which the plants first producec rops in commercially marketable quantities. States that if this policy of expense capitalization is adopted, interest costs and real estate tax costs should not be capitalized.

Is capitalization of expenses a correct method.—States that capitalization of expenses does permit a recovery of certain ordinary expenses at capital gains rates. But this result occurs in any case where growth property is purchased by the use of borrowed funds, except to the extent that rules on excess investment interest limit the deduction. As an alternative, a recapture method would be suggested.

Made the following comments during the discussion:

The proposal to require farmers to adopt accrual accounting methods is unacceptable. Farmers, it is suggested, are not businessmen as we normally think of businessmen. They are not used to the accrual method of accounting.

The extension of section 1245 to cattle or livestock has also been ineffective, particularly with regard to livestock raised which would have no depreciable basis. Even if, for example, cows did have a depreciable basis, upon the subsequent sale, they would not likely be worth much.

The presumption that all livestock is held for sale is a better policy than what we now have. It would not end, however, unfair competition because of the graduated tax subsidy given to high-bracket taxpayers.

Herrick K. Lidstone, Battle, Fowler, Stokes & Kheel, New York, New York (Panel No. 5):

Inventory requirements

Points out that promoters and tax advisers combined in the 1950's and 1960's to exploit the farm cash method on behalf of high bracket taxpayers who derive their income from non-farm

sources. The promotional efforts were directed primarily toward breeding cattle and orchards, primarily citrus, on the much-publicized basis of deducting development expenses as incurred and turning the zero basis "improvements" into capital gains. In commenting on the proposals that inventories be required for farmers, states that since 1922 the Internal Revenue Service has taken the position that growing or standing crops cannot be included in inventory unless the crops were purchased. One exception to this rule, which is not used very often, involves the use of the crop method. This method can be used only with the consent of the Internal Revenue Service and where the farmer is engaged in producing crops which take more than a year from the time of planting to the processes of gathering and disposal. In this case deductions must be taken in the taxable year in which the gross income from the crop has been realized. Goes on to argue that unless growing crops can be inventoried, inventories are not very useful in most farming operations because the other two types of inventory valuation methods approved by the Internal Revenue Service, the unit-livestock method and the farm price method create significant distortions of income.

Argues that while manufacturers can easily determine direct costs and use cost accounting systems to allocate overhead expenses to the units produced, in an agricultural operation such as ranching, in which most of the taxpayer's costs are likely to be costs of land ownership and maintenance and other overhead and indirect expenses, the deduction of these costs as costs of goods sold would involve allocations to various classifications of breeding stock, animals held for sale, and other ranch products which would be largely arbitrary. Furthermore, since many ranches employ little labor other than that needed for routine operations such as maintenance of fences, and purchase a little feed, in most cases the prime costs and other hybrid methods would result in the capitalization of relatively small amounts. Therefore, an inventory requirement for breeding stock would not necessarily have a substantial effect on the amount of capital gains realized in many cases. Argues that he would not object to a requirement that farmers maintain inventories, although it would not produce as much revenue as many argue and would present complicated administrative problems, if farmers were permitted to use the crop method or some other actual cost inventory method, if depreciation could be claimed on the inventoried value of a heifer removed from inventory and transferred to breeding stock, and if the holding period for livestock actually used for draft, breeding, or dairy purposes is reduced to the same six-month period provided for capital gains treatment of the capital goods of manufacturers and other producers. Furthermore, he goes on to point out that the maintenance of inventories must be coupled with other answers if the misuse of the capital gains provisions is to be prevented.

Suggested legislative changes

Argues that the following four points should be seriously considered if it is desired to eliminate the short-term investor only interested in the farm tax accounting rules and to continue to not penalize livestock farmers. First, suggests that all cattle should be inventoried until they have reached breeding age since it is not good

farm practice to breed either a heifer or a bull calf until it is at least 15 to 20 months old. Second, where the facts indicate that promotional literature or surrounding circumstance disclose a preconceived plan to sell or incorporate the herd when developed, or to sell the progeny of rented cows, there should be little question that the animals which were acquired or produced were thereafter held for sale. Third, if deliberate operating losses are realized for a series of years during the buildup of a herd under a plan to maximize tax benefits rather than operational opportunities, it should be determined whether the losses are deductible. Fourth, if rent is paid on a cow to obtain her calf, it should be determined if the rent was not in fact the purchase price of the calf.

States that since the maximum tax on earned income is 50 percent, he is not concerned with cattle feeding or winter vegetables tax-deferral schemes since not only are the chances of recovering your investment relatively low because of the high promotion costs of such programs, but that 50-percent maximum rate is converted in the next year to a higher rate because the amount returned the next year is not earned income. Furthermore, income shifting possibilities will continue to exist in agriculture even with inventories since the farmer who maintains inventories may accelerate or defer the sale of his produce as easily as one who does not.

Agrees that the conversion of deductible agricultural development costs into capital gains is a matter which the Congress should correct, even though "equity" suggests comparable corrections should be made for otherwise deductible development expenses in other fields of endeavor. Argues that the requirements that capitalization of development costs in the case of citrus and almond groves is required discriminates against the owner of developing citrus and almond groves and in favor of other tree crops. Points out that the four taxable year capitalization requirement in that provision is arbitrary. Argues that if Congress desires to use this approach, it will almost certainly be forced to leave the fixing of the period for capitalization of development costs to Treasury regulations. Furthermore, suggests that the depreciation of the capitalized development costs should commence with the taxable year following the development.

Furthermore, recognition should also be given to the fact that groves in some development years, particularly oranges in the better alternate-bearing years, will produce gross receipts in excess of harvesting and marketing costs. In these years, only the excess of developments costs over net receipts from the sale of the product should be capitalized and the net receipts should be used as an offset against development costs. Points out that if land is rented, rather than purchased, the rental cost is deductible since it is not for planting, cultivation, maintenance, or development. Argues that the distinction between development costs of farming and those of newspapers and magazines is unjustifiable. Suggests that Congress abandon the forced capitalization approach to prevent current deductibility of development costs and that instead any net farm loss during the development period be accumulated on a separate farm basis, activity or property basis and be recaptured in the same way as de-

ductions for soil and water conservation expenditures and for land-clearing expenditures are recaptured under the provisions dealing with gain from the disposition of farmland. Argues that it would not be unfair to require that all accumulated farm net losses on each separate farm business, activity or property basis, in excess of interest expense, taxes, and depreciation of real property, be recaptured without time limit under the theory of the personal property depreciation recapture rules. Would further require the accumulation of the farm net losses during the development period from the first dollar without distinction as to whether the farm loss from a particular farm business was deducted against non-farm income or income from other farming activities and without reduction or addition for post-development period profits or losses.

Also suggests that the presumption contained in the present hobby-loss provisions be reversed. The burden of proof should be on the taxpayer unless he realized net income from the activity in each of at least two years out of each period of five consecutive years. If this test is not met all development expenses deducted during the grace period should be retroactively disallowed or in the alternative included in the gross income. However, believes that it would be far better to abandon the present hobby-loss provisions and return to the pre-1970 provisions dealing with the limitation on deductions allowable to individuals in certain cases. However, the $50,000 rule should be modified in these prior provisions so that if the taxpayer's losses exceeded $50,000 per year for five consecutive taxable years, all deductions would be disallowed above gross income from the activity after the completion of the development period. This rule would apply only to the extent they exceed one percent of the taxpayer's gross income from all sources (other than the activity) for two or more years out of any five consecutive years unless, during the five-year measuring period, and the aggregate losses from the activity were less than two percent of the aggregate gross income of the taxpayer from all other sources during the same period.

Also proposes several modifications of the present excess deduction account rules. For instance, suggests that there should be allowed a carryover of profits from profitable years to offset years of substantial losses. Also suggests that these provisions be applied on a farm property-by-property basis or on a farm activity-by-activity basis. If this suggestion is approved it is also necessary to eliminate the $25,000 exclusion and the accumulation of an excess deduction account with respect to each farm property or activity from the first dollar as is now provided in the case of corporations and trusts. The $50,000 limitation should be lowered to $10,000 to $20,000. Depreciation recapture for the disposition of personal property should be used to reduce the excess deduction account. Development costs not recaptured as a result of these provisions and the provisions dealing with the disposition of certain farmland should be recaptured from any gain in the case of land. Lastly, since the excess deduction account rules are designed to induce farmers to adopt proper accounting methods, argues that it is difficult to understand why if a farmer has done so he should not be allowed statutory deductions comparable to those allowed to accrual-basis taxpayers in other industries.

Mandatory adoption of accrual method

Expresses the belief that to put all farmers on the accrual method would be a disaster and would promote confusion. Believes that the real emphasis should be on a normal method of accounting in the sense of recapture of development losses in all fields of tax shelters. Expresses the belief that it is really the promoter who makes the money on the deferral deals, not the investors.

Objects to the proposal that farmers only get capital gains if they use the accrual system. States that the accounting method is not the device that creates the capital gains. If you go on the accrual method of accounting to create inventories based on cost you are simply back to the situation you are at present.

Claude M. Maer, Jr., Holland & Hart, Denver, Colorado (Panel No. 5):

General comments

States that the investment by nonfarm investors in cattle breeding has largely been eliminated as a tax shelter by certain provisions of the Tax Reform Act of 1969 which were proposed and supported by the industry. Feels that, to the extent that cattle feeding is being used as a tax deferral device, this abuse can be prevented by simple adjustments to the tax laws to eliminate the quick in and out tax profiteer.

Prepayment

States that prepayment of feed costs has a sound business basis, and it frequently results in cost savings since cattle feed is less expensive following the fall harvest than later on in the year. Comments that permitting a one-year tax deferral by allowing the deduction for prepaid feed is a small price to pay to have permanent investments in livestock.

Accounting methods

States that the cash method of accounting traditionally used by livestock raisers and farmers is simple and workable, and recommends that it be maintained. Feels that abuses of the cash method have been and can be corrected by simple changes in the tax laws, and drastic changes suggested by some would merely result in more complexities and problems in administration. States in response to a question, that to require all corporations to be put on an accrual method of accounting, would discriminate against the many small family corporations.

Excess deductions account

Favors repeal of the excess deductions account, enacted into the law by the Tax Reform Act of 1969. States that it is discriminatory, much too complicated, and is in reality a trap for the unwary.

Hobby losses

States that the hobby loss rule, also enacted in 1969, is simple and workable and should be retained, but suggests that the presumption period in the case of cattle and sheep should be extended to seven years as in the case of horses.

PANEL NO. 6—MINIMUM TAX AND TAX SHELTER DEVICES

J. Waddy Bullion, Dallas, Texas:

Minimum tax

Application of minimum tax to corporations.—Opposes the application of the minimum tax to corporations. Points out that the minimum tax as initially imposed was not intended to apply to corporations because the 4 tax-exempt items involved would appear in a significant degree only in a few industries and it would be more appropriate to deal with them with respect to the tax structure of those industries after an analysis of their particular economic and competitive positions.

Percentage depletion as a preference item.—Opposes the inclusion of percentage depletion as a tax preference item in the minimum tax. Points out that percentage depletion as a preference item has a great impact on corporations and although affecting all corporations owning nature recourses, it has a great effect on small corporations. Points out that the percentage depletion deduction was reviewed and reduced in the Tax Reform Act of 1969 and that the inclusion of it in the minimum tax has the effect of further reducing the percentage depletion deduction. Believes that since the percentage depletion deduction is peculiar to natural resources industries, it should be dealt with at the industry level rather than relating to all taxpayers generally. Points out that there currently is an energy crisis and that incentives must be provided to assist the industry.

Intangible drilling and development costs as a preference item in the minimum tax.—Points out that although intangible drilling and development costs presently is not a tax preference item, it is suggested by others that it should be added as a preference item on which the minimum tax is computed. Strongly opposes the inclusion of these costs as a tax preference item. States that the deduction for intangibles has application only to the oil and gas industry and should be dealt with in relation to the needs and requirements of that industry and not considered separately as an item of tax preference. Believes that the intangible deduction gives impetus to exploration and is a needed tax incentive.

Credit the minimum tax against the regular income tax.—Points out that an amendment to the minimum tax in 1970 allows a 7-year carryforward of the excess of regular income tax over tax preferences items of the particular year. Indicates that the converse of this is not true; that is, where a taxpayer in earlier years pays little or no regular income tax and a high minimum tax, there is no adjustment in a later year where he may pay a low minimum tax and high regular income tax. Proposes that the minimum tax be carried forward for an unlimited period as a credit against the regular

91-177—73——5

income tax and that it should be retroactive to the first year of the imposition of the minimum tax.

Drilling funds

States that there are basically three types of drilling programs (although many variations) in the industry today—(1) programs in which all or virtually all of the participants are oil and gas operators; (2) private programs which are managed by an oil and gas operator and in which the participants make private investments (not requiring SEC registration); and (3) public programs which are managed by an oil and gas operator and in which units are sold to the public after registration of the units with the SEC. Points out that the one common tax element to all three types of programs is that they must provide for a flow-through to the participants of the income and deductions accruing to the program (unless the programs qualify as associations taxable as corporations), since practically all drilling programs or funds are conducted by limited partnerships or joint ventures.

Points out that each of these funds makes available to either a venture or an exploratory program funds which would not otherwise be available to it. States that no program proliferates deductions and that each participant in a fund derives deductions and credits only from his own contribution. Points out that these deductions are allowed by the Internal Revenue Code and because of the energy crisis no change should be made in the tax laws respecting oil and gas operations.

Responds during the discussions that there are legitimate programs that have no overload in them. Points out that the programs allocate deductions and share expense and pay overhead to the operator but that there is no overload as far as raising money in connection with private drilling funds where there is no public solicitation. Indicates that to his knowledge there is no payment to any broker or agent for raising funds on behalf of the oil and gas operator. States that it does incur the normal business expenses such as travel and attorneys fees but that the funds are devoted practically all to the actual drilling of oil.

Wayne E. Chapman, Cravath, Swaine & Moore, New York, New York (Panel No. 6):

Retroactive repeal

Argues against the retroactive repeal of tax incentives. Cites several bills introduced in the last Congress which would have subjected to recapture fast depreciation on residential housing which was allowed under the Tax Reform Act of 1969. Argues that such proposals would be unfair to taxpayers who had made investments in residential real estate during the period 1969 to 1972 and that changing the tax law to affect transactions already consummated is generally undesirable and should only be done if taxpayers are taking advantage of the tax law in an unexpected way. Believes that the tax law should never be changed retroactively where investors are taking the very action that Congress sought to achieve when it granted the tax incentive in the first place; otherwise, the business community would lose

faith in tax incentives, and Congress would lose the ability to bring about social and economic change through the tax laws.

Grants for housing

States that in lieu of tax incentives, the housing problem might be solved by making housing grants to low- and moderate-income individuals. Believes, however, that unless sufficient funds are appropriated so that grants could be made to all people in need of proper housing, it will be difficult to avoid the abuse of granting such subsidies in a manner which will serve the political ends of the administration in power; moreover, there would be substantial administrative costs connected with such a program.

Local real estate development

Opposes tax reform proposals—such as proposals to amend the partnership rules to limit an investing partner's real estate deductions to the amount of his equity interest in the project—which might have the effect of driving small, local enterpreneurs out of the real estate business. Believes real estate investments are made most wisely by local groups, who have a knowledge of local conditions. Believes that unwise reform of the real estate investment tax provisions might mean that housing and other real estate development would have to be financed, if at all, by large corporations without a knowledge of local needs and conditions.

Minimum tax

Opposes suggestions to tighten the minimum tax provision. Believes that the use of such provisions in general is not desirable because this mechanism avoids the question of whether the benefits that society obtains from particular tax preferences are worth their cost. States that if Congress does not believe that current tax incentives in a particular area justify the cost to the Treasury, it should repeal those incentives rather than attacking them indirectly through means of the minimum tax.

Indicates that any change in the tax incentives in the housing area would reduce the construction of housing, and would drive housing costs upward.

Milton A. Dauber, Geo Resources Management Corporation, Jenkintown, Pennsylvania (Panel No. 6):

Relating drilling funds to the economy

States that a substantial segment of the total capital available to the smaller independent oil companies has been gathered through limited partnership syndicates commonly called drilling funds. Points out that most recent data indicate that during 1972, drilling funds made available some $360 million for new exploratory and development drilling, an increase of 5 percent over 1971 level.

Questions at issue

Suggests that there are three major policy questions with which the committee should deal—(1) Have the drilling funds performed sufficiently well relative to oil industry standards so as to justify their continuance as a feature of our incentive-oriented tax law? (2) Should not drilling funds be allowed the same benefit from the use of credit,

including exploration advances secured by a mortgage upon the properties to be drilled but without personal liability on the borrower as is permitted to the giants of the oil industry and indeed as is permitted in other industries such as real estate which compete for the risk capital dollar? and (3) What changes should be made in the laws relating to the drilling funds to satisfy critics who regard drilling fund deductions as contributing toward inequities in the tax system as a whole?

Drilling funds and the oil industry

Points out that the drilling funds contribute 6 percent of the total expenditures within the United States of the entire oil and gas industry and that while it is difficult to separate the independent from the majors available data suggests that in the so-called independent segment drilling funds contribute 15 to 20 percent of total exploratory capital.

Risk capital factors

States that tax incentives enhance new capital formation in a free society. Instead of consuming profit or income from one source of economic activity, capital building requires that it be reinvested in the development of capital assets in the same or another industry. Believes that if the risk in an industry is high, then the potential reward likewise should be attractive if new capital is to be secured. Points out that because only one well in ten is a commercial producer, tax incentives have induced new dollars to assume the risk of these odds.

Fund management

Indicates that the profile of drilling fund sponsors and management that existed in bygone days is not today's profile but that active management and large numbers of trained personnel is the norm today. Estimates that a well-run drilling fund has administrative costs that run on the order of 20 percent of the money raised.

Cost per barrel of discovery

Suggests that because drilling funds can find oil in the same cost range as the industry as a whole, they should be considered a bona fide business venture rather than as a tax shelter device. Suggests further that drilling funds pay their own way by contributing significantly to domestic exploration.

A leveraged fund

Points out that a drilling fund is the financial device of nonrecourse financing or leveraging which enables the investor to take a deduction for intangible drilling costs expenditures resulting both from his own investment and money borrowed nonrecourse; thus, the allowable tax deduction will exceed cash outlay in the first year. Points out, further, that as a corollary, in future years, debt service and repayment will reverse the situation; that is, tax burden will exceed cash flow. Indicates that leveraging reduces the net investment costs and suggests that this is a way to make the risk/reward ratio acceptable.

Indicates that in regard to the financial arrangements, the drilling fund gives a nonrecourse promissory note secured by a lien on the entire group of drilling prospects supplied by that operator. Points

out that the operator enters into this type of credit arrangement because of his capital need.

Leverage—drilling funds and the Crane case

States that the effect of the *Crane* case (although it specifically involved real estate depreciation) is to allow tax deductions in excess of cash investment and that judicial sanction of the application of the basic *Crane* idea can be found in a variety of cases. Suggests that in 1969 *Crane's* applicability to oil and gas exporation and development was confirmed legislatively in code sec. 636. Believes that the Service has respected *Crane's* basic applicability to drilling activities.

Proposals to limit Crane

Indicates that the wholesale efforts to repeal the *Crane* rule has been discouraged because of immense administrative burdens. Suggests, for example, that in H.R. 1040 (the bill introduced in the 93d Congress by Mr. Corman) great care was taken to restrict repeal of the *Crane* rule to only one situation namely, investment in rental real estate. Suggests that a reading of section 313 of H.R. 1040 shows that the proposal does not abolish the *Crane* rule as applied to the partnership entity but merely repeals reg. § 1.752–1(e) which gives a limited partner an immediate addition of partnership non-recourse indebtedness to his basis for his partnership interest.

Points out that although nonrecourse financing in drilling funds allows deductions in excess of cash outlay, in subsequent years the nonrecourse indebtedness must be paid either out of production from properties which prove productive, or else through foreclosure upon the property. States that, admittedly, there is more than mere tax deferral to this since the benefits of percentage depletion and of the capital gain rate structure produce a lower effective rate.

Gas company advances—FPC Order 465

Suggests that FPC (Federal Power Commission) Order 465 which governs advances in the lower 48 States acknowledges that gas advances have been a significant factor in bringing forth new gas supply and that this has been of significant benefit to the smaller independent companies. Suggests that this order acknowledges that when the FPC eliminated the exploratory and nonrecourse features from rate base under its earlier orders, there was a sharp drop in advances.

States that it is said that Order 465 requires that advances must be recourse but that this is not the case—what the order requires is that the advances are to be repaid in full by either delivery of gas or other consideration. Suggests that Order 465 does not require pledging the full faith and credit of the borrower.

Gas company advances—tax treatment by borrowers

Suggests that the Federal Power Commission has characterized the advances as true loans and has encouraged the producer/borrowers to treat the loans as part of their cost of drilling and accordingly, to take intangible drilling costs deductions for drilling costs attributable to the borrowed funds.

Offshore exploration companies

Points out that major oil companies which form subsidiaries and then have the subsidiary issue to the public subordinated convertible

debentures plus common stock engage in tax leveraging in a fashion similar to drilling funds.

Tax incentive and leveraging

Points out that in most cases of a conventional fund, even after allowing for tax benefit, the investor has a net out of pocket cost rather than a net profit and that to this extent the incentive does not work. Indicates that conventional fund investors, as a whole, lost money about as frequently as they profitted.

Indicates that data generated from studies have suggested that if conventional funds had been leveraged, they would have shown a profit, in all years studied, except one, and on a weighted average basis over 99.9 percent of the dollars invested in funds would have produced a profit. Suggests, therefore, that in the long run leverage (or some other added incentive) will be necessary to maintain the flow of drilling fund money.

Believes that as investors become more and more sophisticated, the rate of return for conventional drilling funds will not be acceptable in comparison to the rate of return derived from leveraged funds.

Believes that if the *Crane* rules are overturned, there will be a sharp decline of investor money flowing into drilling activities.

Use of funds for exploration for new reserves

Proposes that a most fruitful approach would be to restrict intangible drilling costs of drilling funds to wells which are defined as exploratory either under the technical definitions of the American Petroleum Institute or which are certified as exploratory under applicable State law. Suggests that in order to make everyone pay his fair share of income tax, perhaps the amount of intangible drilling expense allowable by persons not actively engaged in the oil business should be restricted to a certain percentage of gross income. Suggests, further, to allow a standard credit against tax of 50 percent of a taxpayer's investment in new domestic exploration regardless of form, which would increase the amount of money going into domestic drilling and, in effect, put the middle income taxpayers' deductions into the 50-percent bracket.

Should fund investment be limited to a percentage of income

Suggests that a limitation on the percentage of gross income which an individual may shelter under intangible drilling costs with a carryback and carryover of any amount of IDC unused or unusable within the year by reason of the limitation is a good approach. Suggests that this is preferable to a straight dollar limitation because the taxpayers with the larger incomes are in the best position to assume exploratory drilling risks.

Favorable net tax rates on sale of oil and gas or of discovery properties represent a well-settled, carefully chosen policy of 50 years vintage

Points out that the overall net economic profit which can be derived from a drilling fund is the function of ordinary income deductions being returned to the investor in a subsequent year as capital gain. Suggests that this is an intended tax benefit granted by section 632. Believes that if the sale or exchange of mineral properties by individuals is subjected to ordinary income taxation, risk dollars will

diminish. States that the proposal to limit intangible drilling cost benefits to genuine exploratory efforts and to development wells resulting from genuine exploration will knock out the one situation in which the tax rate differential between the deduction and the return can be deemed abusive.

Use of a tax credit instead of an intangible deduction

States that an equity reform which would increase the amount of money flowing into drilling activity while at the same time distributing money more widely into the middle brackets would be to provide in lieu of the intangible drilling cost deduction a credit (subject to a dollar limit) against tax equal to 50 percent of any taxpayer's investment in new domestic exploratory drilling.

Martin D. Ginsburg, Weil, Gotshal & Manges, New York, New York (Panel No. 6):

Impact of minimum tax

Summarizes the legislative history of the minimum tax and discusses the impact of the minimum tax on taxpayers with high gross income. Concludes that, in general, the exclusion of tax-exempt interest and special deductions, such as intangible drilling expenses, still permittes a large numuber of individual taxpayers with substantial gross income to report a comparatively low adjusted gross income and incur indefensibly minor Federal tax liability. Describes, for example, one case described in the Johnson Treasury Study where taxpayer had a real income of $935,000 and an effective rate of tax of 14.7 percent; under present law, this effective rate was increased to 17.5 percent. Another case was a taxpayer having approximately $1,500,000 of income from oil and gas operations (after reductions for exploration and development, intangible drilling and other costs), $670,000 of long-term capital gains and $120,000 of miscellaneous income. Under prior law, this individual paid no Federal income tax. Under present law, the effective rate measured against this income is 6.7 percent.

Tax planning tools

Explains the methods that tax advisors use in planning for the minimum tax—a formula has been devised to determine the maximum amount of tax preferences taxpayers, at different gross income levels, may incur and pay no minimum tax. (For example, a taxpayer with an ordinary gross income of $300,000 may incur approximately $131,000 of tax preferences and pay no minimum tax.) Points out further that the large number of preference items not included in the minimum tax base permits taxpayers to obtain the benefits of many tax shelters (such as farming) without being subject to the minimum tax. Notes that while many of the preferences have defenders who advocate their retention for reasons of economic and social policy, some of the preferences are difficult to defend on such a basis. (For example, taxpayers who use plant nursery operations as a shelter.)

Effect on capital gains

States that the preference for one-half of long-term capital gains has little impact since a taxpayer in the 70 percent bracket incurs

3 cents of minimum tax for each $2 of long-term capital gain that he realizes. Indicates that this is due to the fact that the 70 cent regular tax is an exclusion on the dollar of preference income, leaving a 30 cent preference; thus, the minimum tax is not likely to have much impact on investors seeking long-term appreciation capital gains.

Proposals

Makes three specific suggestions with respect to the present exclusions in the minimum tax: (1) the $30,000 exclusion is too high and should be reduced to not more than $20,000; (2) the exclusions for current and past income taxes should be eliminated; (3) the net operating loss rule should be repealed and the Treasury should be encouraged to reexamine its complicated proposed regulations which contain administrative limitations on the definition of tax preferences in order to provide a tax benefit rule. Suggests also that the minimum tax base be expanded to include the significant preference items that were enumerated in one or another of the Johnson Treasury Studies, the Nixon Administration proposals, and the 1969 House Bill, which are not included in the present definition of tax preferences.

Kenneth A. Goldman, Irell & Manella, Los Angeles, Calif. (Panel No. 6):

Minimum tax

Says the minimum tax is a sound concept but needs to be strengthened to accomplish what the public thought was being effected in 1969.

Suggests that goals of minimum tax are the following: (1) assurance that each person or corporation above a minimum income level contribute meaningfully to the cost of government; (2) imposition of a significant tax on persons otherwise paying a relatively smaller share of taxes than those similarly situated; (3) reduction of the disparity of tax burdens among persons having similar economic incomes; (4) imposition of a meaningful tax upon those who accumulate so many tax preferences that they pay little or no regular tax; (5) increased revenue; and (6) reduction of the attractiveness of "tax shelter deals."

States that if Congress retains any tax subsidies, then "minimum tax is essential to lessen * * * distortion" that results when "a taxpayer has so overly accumulated so many of the tax preferences and tax subsidies that he has reduced his tax consideration to the government to such a low relative rate that it is so dissimilar to similarly situated taxpayers, wage earners, persons with similar incomes, and it creates the disparity" shown in examples in which taxpayers, each with $300,000 of economic income, pay taxes ranging from 0 percent (municipal bond interest) to 9 percent (income sheltered by accelerated depreciation) to 27.09 percent (capital gains) to 47.35 percent (wages) to 60.33 percent (dividends and interest).

Notes that wage earner with $32,000 of salary pays taxes at about the same effective rate as individual with $300,000 of capital gain income, even including present minimum tax.

Urges scope of preferences be expanded to include:

(1) municipal bond interest;

(2) intangible drilling costs;

(3) difference between effect of credit for foreign income taxes and effect of deduction of those taxes;

(4) tax subsidy effect of farm deductions deferral;

(5) unrealized appreciation on property donated to charity, to extent it gave rise to charitable contribution deduction;

(6) life insurance proceeds;

(7) prepaid expenses where prepayment not required for valid business purposes; and

(8) research and development costs that otherwise should be capitalized.

Urges progressive minimum tax rates not less than half the regular tax rates (i.e., from 7 percent to 35 percent); if this is done, then present $30,000 floor could be left intact.

Believes stock option should not be treated as preference until the stock is sold, exchanged, or hypothecated; but amount of preference should be calculated as at present.

Urges retention of present interrelationship between minimum tax and section 1348 maximum tax.

Urges revival of allocation of deductions proposal, in addition to present minimum tax; concludes that, with appropriate floor, the provision would not be complex to administer, particularly in relation to the logic and equity behind it.

Urges that, since for many tax devices the major tax benefit is the deferral, the value of the deferral should be included in the minimum tax base.

Tax shelter devices

States that although many tax shelter devices were created by Congress to achieve specific purposes, many have in fact been used to achieve purposes Congress had no intention to subsidize. Gives as example a syndicate offering investments in an "underground movie", in which an individual investing $32,000 was offered tax deductions (although perhaps subject to recapture) equal to $110,060 in the first year plus an investment credit of $10,547; for a taxpayer in the 50 percent bracket, this would result in actual tax savings of $65,577, a profit in one year of $33,577 due entirely to the tax aspects of the deal rather than its economics. Notes that other syndicates have been established to produce pistachio nuts, grapes, movies, and housing units which have in some areas far overtaken demand.

Maintains that, even where tax subsidies are intended, substantial amounts are diverted from the activity intended to be subsidized. Gives example of diversions from actual oil drilling of up to 15 percent for commissions to NASD broker-dealers, attorneys, and accountants; management fees as high as 20 percent; and substantial profit participations granted to the syndicators.

Asserts that the major provisions relied upon for tax shelter syndications are the following:

(1) increase in basis resulting from nonrecourse loans (sometimes these loans are made by the general partners to limited partners)—such a loan, for which the limited partner will never

be liable or have capital at risk, is a device running through virtually all syndications, from oil to movies, and is available because of the regulations under section 752;

(2) current deductibility of intangible drilling costs, exaggerated by current deductibility of prepaid intangible drilling costs (leveraged by nonrecourse borrowing);

(3) prepayment of interest;

(4) availability of cash method of accounting for farmers (which is frequently used by syndicators rather than small farmers);

(5) accelerated depreciation, especially when in excess of the taxpayer's equity;

(6) availability of investment credit to syndicates, exaggerated by the leverage of nonrecourse loans so that, if leverage exceeds 93 percent, credit produces instant profit by excess over taxpayer's investment;

(7) first-year bonus depreciation, which was intended for small business but is utilized by many high bracket businesses and individuals (the deduction, although limited in amount, reduces income otherwise subject to the taxpayer's highest tax bracket);

(8) prepayments of management fees, feed and agriculture expenses, license and royalty fees, and other expenses; and

(9) municipal bond mutual funds.

Suggests several proposals to alleviate some of the distortion caused by the syndication of tax shelters, as follows:

(1) farm losses passed through a limited partnership may not exceed farm income (alternatively, cash method of accounting not to be available to farming operations larger than specified size);

(2) tax basis attributable to nonrecourse loans may not exceed taxpayer's equity or risk (suggests this be used to limit basis for depreciation and investment credit);

(3) create SEC-type enforcement mechanisms to assure that tax shelter programs trading on tax subsidies do indeed allocate investment dollars to the activities Congress intended to subsidize; and

(4) prohibit deduction of prepaid interest except during the period the interest accrues, in order to assure proper matching of income and expenses.

Urges that limited partnerships generally be put on an accrual basis in order to restrict deductions for prepaid items. Asserts that accrual accounting will work no hardships on tax syndicates and would not apply to small farmers.

Notes that tax syndicates have been defended because of energy crises, housing crises, and perhaps rose bush crises, but that they may lead to taxpayer crisis which puts voluntary tax system in danger.

Urges that among tax benefits there be recognized by Congress the value of deferral; in many cases, the "name of the game is deferral".

Professor Paul McDaniel, Boston College Law School, Brighton, Massachusetts (Panel No. 6):

Suggests that in order to restore equity and yet continue to provide certain activities with tax expenditure assistance, three approaches to

the tax shelter problem should be considered: (1) placing direct limits on the elements of the tax shelter itself; (2) eliminating the trafficking in tax shelters by replacing present tax provisions with tax benefits that are available only to those engaged in the activity to be assisted; (3) strengthening overall limitations on the use to which individuals and corporations can take advantage of preferential tax rules.

Suggests that even if provision of assistance through the tax system is desirable, the problem is that every time Congress enacts a tax preference for a particular industry or economic activity, there is a highly skilled band of tax and financial advisers ready and able to convert that tax provision into a tax shelter for their high-bracket clients. Another problem is whether the marketing of these tax benefits through syndication assists in providing Federal tax funds to those actually engaged in the activities to be aided, or whether the Federal aid is being syphoned off by persons who are really unconnected with the activity. If the latter is the case, attention should be focused on steps that can be taken to reduce or eliminate the trafficking by high-bracket individuals and corporations in tax provisions that were intended to benefit a particular industry or activity.

TAX SHELTER DEVICES:

The syndicated real estate tax shelter

Elements of the tax shelter.—States that the elements of the tax shelter are as follows:

a. *The shelter* of income other than that derived from rentals of real estate as the result of the excess deductions generated by accelerated depreciation and interest deduction.

b. *The deferral* of tax resulting from accelerated depreciation.

c. *Leverage* which enables the investor to obtain deductions at a faster rate than he make his equity investment in the property and in excess of his actual investment.

d. *Capital gain* treatment upon ultimate sale of the property. In effect, a requirement that the taxpayer repay only a part of the loan previously made by the government through the deferral mechanism.

The syndication of the tax shelter.—Points out that the above factors provide a substantial benefit to those who can use them. Argues that presumably in the case of residential real estate, the tax benefits were intended to provide financial assistance to those engaged in the business of developing housing. The actual developer may not be able to fully use tax benefits provided for real estate. Moreover, these benefits are realized over time and the developer usually desires immediate compensation. The answer to these developers' problems is to employ others to syndicate these tax benefits and sell them to a large number of investors. A syndication is made by regulations applying to limited partnerships, the rule developed in the context of individual taxation that a taxpayer is entitled to include in his cost basis for depreciation purposes the amount of nonrecourse mortgage.

Suggests that the question is whether the syndication of tax benefits achieves the desired goal in stimulating residential rental real estate construction. Using the FHA financed project discussed in Mr. Kurtz's statement as an example it is evident that the lack of Federal funds to

compensate the developer made it necessary for him to sell the tax losses to compensate himself. The purchasing investors paid the developer less than the present value of the tax losses that would be borne by the Treasury. The Treasury should itself measure the present value of these tax benefits and determine the revenue loss and evaluate whether that is the most efficient way to compensate the developer.

Evaluation of the syndicated real estate tax shelter.—Describes the evaluation of the real estate transaction as based on the following assumptions: the present discounted value of the revenue loss, assuming a borrowing rate of 6 percent and average 60 percent marginal rate for the investors and capital gains treatment on the sale of the project after 20 years, shown in the example contained in the testimony by Jerome Kurtz was over $2 million. Of this $2 million, $600,000 went to the investor group and of the remaining $1.4 million, $210,000 went to the underwriter salesman, lawyers and accountants involved in the syndication process so that the developer received a fee of under $1.2 million, approximately 10 percent of the project cost. To provide the developer with $1.2 million, the Treasury spent $2 million, a waste of $800,000 of Federal money. Suggests that obviously an alternative tax provision such as a credit available directly to the developer could be designed which would eliminate this $800,000 waste.

The oil and gas tax shelter

The elements of the tax shelter.—States that the elements of the oil and gas tax shelter are as follows:

Deferral comes from expensing intangible drilling and development costs rather than capitalizing them.

Shelter of nonoil income results from the fact that production does not usually take place in the year in which the intangibles are incurred, hence these deductions are offset against income from sources other than property.

Capital gains element results from the failure to recapture previously deducted intangible costs upon sale of the property.

Leverage is available in the form of nonrecourse loans for the bulk of the intangible costs.

Percentage depletion provides an additional tax benefit.

(A detailed numerical example of the operation of these provisions is provided and separate sections show the operation of leveraging and syndication in a manner similar to the real estate example.)

Argues that in a manner similar to that of the real estate case, the Federal Government has paid a considerable amount to the syndicators rather than to the actual producers of a well. The question is, if the purpose of the tax provisions is to provide assistance to drillers to explore and develop new reserves, why is it necessary to incur additional revenue losses to channel these funds through a syndication process rather than paying them directly to the developer?

Equipment leasing tax shelters

The tax benefits.—The investment credit, accelerated depreciation (including ADR) plus the deduction for interest on loans provides the tax benefits which are of advantage to high-bracket investors willing to finance the acquisition of equipment. Suggests that a business enters this lease transaction either because the individual lessor

can derive greater benefit from the tax deductions than a corporation (because the individual's tax rate is higher or the corporation may be a loss corporation). In addition, the firm may prefer a lease transaction for reasons of convenience or, avoidance of capital outlay or additional borrowing. Because of restrictions on the use of the investment credit by individual lessors, imposed by the Revenue Act of 1971, individual lessors are involved in accelerated depreciation or 5-year amortization property whereas corporate lessors, normally a bank, are involved where the investment credit plus ADR provides the tax benefits. For individual lessors, the syndication process is selling only deferral but in conjunction with 80 to 100 percent nonrecourse financing. A detailed example showing how this works in the case of a syndicated tax shelter involving 5-year amortization for railroad rolling stock is provided.

Points out that an even more lucrative variation of this leasing arrangement is the syndicated pollution control equipment leasing tax shelter with tax exempt financing. Present law contains an exemption from the industrial development bond rules for bonds issued for qualified pollution control facilities. In this arrangement, an investor group can thereby obtain the benefits of lower interest charges resulting from tax-exempt financing in addition to the other benefits.

Corporate lessors—the equipment leasing tax shelter.—Since the denial of the investment credit to individual lessors by the 1971 Act, corporations have moved increasingly into the leasing business. This is particularly true of banks which have moved into leasing for two reasons: one, the leasing transactions are essentially financing transactions where banks normally operate, and two, since only a corporate lessor can take advantage of the investment credit, banks have conducted the leasing operations directly instead of providing nonrecourse financing to limited partnerships. A bank can offset any losses generated by ADR or the investment credit against its banking income.

Legislative responses to the tax shelter problem

Direct limitations.—Suggests direct limitations as follows:

a. Tax benefits attributable to an activity can be deducted only from income generated by that activity.

b. Tax deferral can be treated as a loan, requiring repayment with interest.

c. The advantage of leverage can be reduced by limiting depreciation deductions to equity investment.

d. The capital gain advantages can be limited by providing for full recapture of depreciation in the case of real estate and intangibles in the case of oil and gas.

Syndication limits.—Provide that limited partners will be entitled to deductions only to the extent of their actual equity in the limited partnership. Nonrecourse loans would not be added to basis. This rule would correspond to present treatment of shareholders and subchapter S corporations. This approach leaves tax benefits intact for individuals and corporations. One difficulty is that it will shift tax shelter leasing transactions to banks and other financial institutions.

Restrict tax benefits to those for whom they were intended.—Limiting tax benefits to the direct user or developer could be provided in the form of a specific tax credit which in the case of a loss or no tax situation could be in the form of a refundable credit. With respect to accelerated depreciation, a more complex variation would be to provide that any unusable depreciation by the actual user would generate a tax refund repayable over the life of the property corresponding to the interest-free loan aspect of the current operation.

THE MINIMUM TAX

Background

Points out that the minimum tax adopted in the Tax Reform Act of 1969 was based on the view of Congress that it did not wish to change the tax rules that provide the basis for tax shelters nor entirely prohibit the syndication of these tax shelters. But Congress did wish to put some overall limit on the extent to which any individual could take advantage of the tax shelters. That is, individuals and corporations should not be able to combine tax preferences in such a way as to completely escape liability. The minimum tax needs to be strengthened, however. The way in which this can be done is revealed by a review of the development of the minimum tax. The 1968 Treasury tax reform studies and proposals proposed a minimum tax as an *alternative* to the regular tax. Under this approach an individual included his tax preference income and his regular income and applied a rate schedule with rates half those of the regular rate schedule. If this resulted in a higher tax than the regular tax, the taxpayer then paid this minimum tax. In effect, the minimum tax was both *progressive* and *comparative*. In April 1969, the Nixon Administration proposed an alternative minimum tax called a limitation on tax preferences (LTP). Under this, the taxpayer could not have tax preferences in excess of one-half of his expanded income (AGI plus defined tax preferences). Any excess over one-half would be included in income and subject to the normal rates. The House adopted this LTP concept in its version of the Tax Reform Act of 1969. It, too, was a *comparative* and *progressive* tax. Combined with both of these minimum tax proposals, went an allocation of deduction system wherein the proportion of deductions equal to exempt income was disallowed.

In 1969, the Senate Finance Committee substituted a flat 5 percent rate on preference income in excess of $30,000 exemption. This changed the structure of the minimum tax considerably in that it became a *proportional* tax and an *additive* tax as compared to a progressive and comparative tax. A Senate floor amendment which the conference agreed to provided a comparative aspect by making the rate 10 percent applicable to preference income minus the regular tax liability.

Suggested improvements in the minimum tax:

Expansion of the Minimum Tax Base

Items that should immediately be included in the minimum tax base:

1. Intangible drilling and development expenses.
2. Interest on tax-exempt bonds.

3. Construction period interest and taxes.
4. Investment credit.
5. Accrued gain on property transferred at death or by gift.

Items that should be studied further for possible inclusion in the minimum tax base:

1. Exclusion of interest on life insurance savings.
2. Net imputed rental income from owner-occupied housing.
3. Social security benefits.

Changes in the Rate of the Minimum Tax

While the $30,000 exemption does provide some progressivity in the minimum tax, the deduction for regular taxes produces a progressivity in the minimum tax that is inverse to the progressivity of the regular tax. That is, the higher the regular taxes, the lower minimum tax and conversely. The result is that two people with identical tax preferences may pay different amounts of minimum tax—a result that is at variance with the additive nature of the minimum tax although consistent with the comparative approach. Therefore, the minimum tax rate structure should be changed to one-half the normal tax rates. For corporations, a corresponding change would be to increase the flat rate to about 20 percent. To insure that the proposed progressive minimum tax rates for individuals operate as a direct supplement to the progressivity of the regular tax the deduction for regular taxes from the minimum tax base should be eliminated.

Change in Exemption

The present $30,000 exemption is unjustifiably large although some exemption is necessary for administrative conveniences. Therefore, a $5,000 vanishing exemption should be provided; phased out so that it disappears once tax preferences equal $10,000. For corporations, no exemption should be provided.

Structural Changes in the Minimum Tax

Treatment of deferral items.—A problem with respect to deferral items arises that does not occur in the case of exemption items. In the case of deferral items, the minimum tax may be imposed on an amount which itself is later subject to regular tax, but present rules do not permit any adjustment in the subsequent year for the minimum tax previously paid. While the minimum tax may be viewed as an interest charge on the deferral when the rate is 10 percent if the rates were increased to a maximum of 35 percent, this degree of inaccuracy would be unacceptable. Therefore, the best solution under higher rates would be that upon disposition of deferral property a tax credit be provided for minimum tax previously paid. A similar result can be obtained by a basis adjustment but this is much more complex.

The averaging device.—Under the present minimum tax, a carryover of regular tax previously paid is permitted in determining the base for the minimum tax. Under the proposal to eliminate the deduction for regular taxes, the question is whether an averaging device should be provided. The need for such a device depends on one's view of the minimum tax. If it is seen as a special tax structure against which an individual's tax preference income is to be checked each year, then

an averaging device is probably not appropriate. Such an approach seems especially justified under the present minimum tax structure. After the proposed revision of the minimum tax, averaging for minimum tax seems appropriate. A 5-year averaging device similar to the present income averaging might be appropriate.

Supportive Provisions for the Minimum Tax

Suggests that even a strengthened minimum tax still leaves some shelter areas untouched. For example, special itemized deduction areas and the farm loss problem. Therefore, the additional steps are recommended; (1) adoption of the allocation of deductions provision as enacted by the House in 1969 with an expanded list of preference items, (2) limitation on interest deduction; the limitation on the extent to which the interest deduction can be taken against noninvestment income should be strengthened by reducing the present $25,000 exemption to $5,000 and disallowing the entire excess deduction rather than one-half; (3) for farm losses rather than the present EDA account approach, the suggestions of the 1968 Treasury tax reform studies and proposals should be adopted which is the disallowance of all deductions for farm "loses" to the extent they exceed farm income plus $15,000.

Responds during the discussion as follows:

Believes that there was considerable agreement among the panelists that oil drilling is risky and requires large infusions of capital, that we have an energy problem and we would like to solve it. It does not follow, however, that the existence or syndication of oil shelter tax funds is the best way to proceed. The question is what is the most efficient means of providing Federal support for a particular activity and does syndication have any role to play in this process in view of the fact that the tax syndication diverts a considerable portion of the revenue costs to the syndicators or salesmen rather than the person performing the activity in which the government is interested. The present approach creates too much wastage of Federal revenue. Nor does the argument that there is no such wastage in the oil drilling business seem to be plausible.

Indicated that it would be preferable to have the system of direct payments to encourage particular activities rather than tax provisions. Pointed out that the 1969 provision for the interest subsidy for municipal bonds was an example of the method of delivering Federal money in the absence of controls. Pointed out that the question is not really tax monies versus other kinds of money, the question is controls versus no controls and it is possible to have the same degree of controls under a direct payment system than is available under the tax system.

Mentioned that the impact on prices of the current tax provisions for oil and gas was dealt with in the study done for the Treasury in 1968 by the CONSAD corporation which indicated that if one repealed almost all the tax shelters for the industry, the price of gasoline might increase something like 2 to 3 cents a gallon.

PANEL NO. 7—PENSIONS, PROFIT SHARING, AND DEFERRED COMPENSATION

Herman C. Biegel, Lee, Toomey & Kent, Washington, D.C.:

Vesting

States if Congress deems it advisable to adopt a vesting standard, then a minmum, rather than a maximum, standard should be imposed. For example, an amount of plan benefits should be vested which, when added to Social Security benefits, equals 50% of the payroll covered by Social Security. If a more stringent standard is deemed imperative, no single formula—whether it be ten years, the rule of 50, the 30% at 8 years plus 10, etc.—should be mandated. A vesting formula which falls within the general parameters of such a standard should be able to qualify. Consideration should also be given to whether the imposition of a vesting standard retroactively on previously accrued benefits is legal. Responded to a question as to what method of vesting is the most liberal method for the employee by indicating that it is a matter of preference but that he viewed the proposal that provides for full vesting after ten years as being the most liberal. Observes further that only 20 percent of the plans do not have vesting and that any of the vesting proposals being discussed would eliminate the worst abuses and hardship cases.

Funding

Notes that available information indicates that a large percentage of plans are adequately funded, both with respect to accrued benefits, as well as vested benefits. If Congress desires to set guidelines, then a 40 (rather than a 30) year period should be permitted for accrued liabilities. Most importantly, however, the experience deficiency provision in the Williams-Javits Bill, and the 4% ratio provision in the Dent Bill, should be eliminated or, at the very least, modified drastically. Congress, and this Committee especially, should also be aware of the adverse effect on the revenues if any funding proposal requires major additional contributions to qualified plans.

Insurance

Believes insurance is highly undesirable. The cases it is designed to cure involve a fraction of 1% of the employees covered. To set up a huge bureaucracy for so negligible a fraction of the pension universe would be foolhardy. Moreover, it would lead inevitably to standardization of actuarial assumptions and complete control of the investment of pension funds. No one has advocated these harsh results, yet without control of these two sides of the equation, the insurance risk could be varied at the will of the insured.

Portability

States that portability is of questionable value and has been rejected by responsible officials of the Administration, Labor and Management.

91-177—73——6

The desired result can be achieved by recording on the Social Security records of each employee the vested benefit under the several plans in which he has participated over his working life.

Administration

States that the tax system is the appropriate mechanism for any changes that are made. The Internal Revenue Service, both in its National Office and in the numerous field offices, already has a substantial administrative staff with remarkable expertise in this field.

Bunched income

Believes that in this year of special emphasis on tax simplification, it would be most helpful if the long-recognized Congressional concern for the bunched-income problem in lump sum distributions from qualified plans could be resolved on an equitable and more simplified basis.

Social security

Indicates that some corporate executives had begun to wonder about the role of private pension plans in view of the increasing role of Social Security in providing for retirement income.

Frank Cummings, Gall, Lane, Powell & Kilcullen, Washington, D.C. (Panel No. 7):

Vesting and funding

States that present laws with respect to the private pension system are inadequate because they do not contain sufficient requirements with respect to vesting and funding. Favors a system of deferred grading vesting, based on years of service, and supports the vesting requirements found in S. 4 (the Williams-Javits bill), which provide for 30-percent vesting after eight years of service, with ten percent additional vesting each year thereafter, until 100 vesting is required after 15 years of service. Argues that vesting proposals which weigh age as a factor tend to result in less hiring of the elderly, impose a burden on the employee's last employer to provide his full pension, and also can result in meaningless vesting, because the pension rights which are vested will be very small in the case of an elderly employee with only a few years of participation in the pension plan.

Argues that adequate funding requirements are necessary to ensure that the promise of a pension will not prove illusory. Favors the proposal contained in S. 4—that current service costs should be funded currently, and that unfunded past service costs should be funded ratably over a 30-year period. Believes that funding requirements should be backed up with a Federal program of pension plan insurance.

Portability

Favors the voluntary system of portability provided in S. 4, in which vested pension benefits of participants requesting portability would be transferred through a Federal clearinghouse in the case of plans which voluntarily agree to participate in the program.

Fiduciary responsibility

Believes that there is a need for additional requirements with respect to fiduciary responsibility in the management of pension plans.

Feels that there is a need to expand the list of "prohibited transactions," to prevent parties in interest, such as the employer or the union, to engage in loan, gift or other transactions with the pension fund and to restrict the amount of pension plan assets which may be invested in employer stock. Believes, also, that trustees of the fund should be held to a prudent man standard in managing the fund's assets.

Enforcement

Believes the power to enforce these new rights should be given to the Department of Labor, or possibly some other public agency. Suggests also that private citizens should be permitted to go into Federal court to enforce their rights. Does not believe that the Internal Revenue Code is an appropriate vehicle for enforcement, since disqualification of the pension fund for Federal tax purposes hurts the employee.

Personal retirement plans

Believes tax incentives should be adopted to solve the problem of employees who are not covered by a private pension plan, or employees, such as engineers, who change jobs so often that they are not likely to be protected under any vesting standard. Favors the proposal contained in H.R. 12272 (92nd Congress) to allow a deduction for contributions to a personal retirement savings plan in the case of an individual not covered under another form of private pension plan (although he believes the maximum deduction should equal $7,500, not $1,500, as proposed under the bill).

Other comments

States that labor unions could not always be depended upon to bargain for adequate vesting rights for their members, because it might be decided to seek other benefits instead. Argued that the Federal Government should set minimum standards in this area.

Makes the point that the proposal in S. 4 to limit the amount of a pension fund's assets which could be invested in the employer corporation to 10 percent was not intended to apply to profit-sharing plans, such as the Sears plan, but only to pension plans, where an employee's rights to a fixed pension could be lost if the plan's assets were invested in a financially shaky employer.

States that the cost of providing adequate vesting would not be excessive, and would probably equal between 0.1 and 0.2 percent of payroll for most pension plans.

States that in the enforcement area some agency should have the right to go into court and put the assets of a pension fund into receivership, where it was felt that the financial security of the fund was being threatened by manipulation.

Professor Daniel Halperin, University of Pennsylvania Law School, Philadelphia, Pa. (Panel No. 7):

Amount and nature of tax benefits

States that present tax benefits on account of qualified pension and profit-sharing plans result in revenue losses of nearly $4 billion annually. Contends that this $4 billion is distributed in an inequitable manner under present law and that administration tax proposals (H.R. 12272, introduced in the 92d Congress) appear designed only to aggravate existing inequities.

Notes that, generally, compensation deductions are available to employers only at about the same time that payments are taken into income by employees, with the major exception to this rule of current matching of income and deductions being for qualified (under sec. 401) pension and profit-sharing plans. Asserts that the most important of the benefits granted to qualified plans is that of deferral—deductions allowed to employers currently while taxation to employees is delayed until actual distribution from plans. Maintains that this mismatching of deduction and inclusion amounts to an interest-free loan from the government, the value of the loan depending on both the amount that is being deferred (the amount of the contribution, plus the plan's tax-free earnings on the contribution) and also on the marginal income tax rates of the employer and the employee.

Justification of tax benefits

Maintains that the social justification for giving such benefits to higher income persons is that, in order to get those tax benefits the higher income persons must see to it that lower income persons are also receiving significant retirement benefits. Believes that the present tax system provides unduly great benefits for higher income persons and fails to produce retirement benefits for many lower income persons.

Notes that about half the work force is not covered by private retirement plans and that the percentage of coverage is lower for companies whose employees' average salaries are lower, and for companies with smaller numbers of employees.

Asserts that the main cause of low coverage in small businesses probably is not lack of adequate vesting provisions, since the Internal Revenue Service usually insists on relatively fast vesting for such small companies; that the main cause probably is unduly restrictive eligibility requirements (age, service) established by small businesses' plans.

Proposals

Recommends three steps: (1) remove or lower age barriers to eligibility, (2) limit the amount of tax benefits that can go to higher paid persons, and (3) insure that those actually covered by private plans will get the retirement benefits they expect.

Limit on benefits for high-income persons

States that issue is not whether there should be a limit on retirement benefits, but whether there should be a limit on eligibility for tax benefits. Suggests that tax benefits be limited to providing retirement benefits of $35,000–$40,000 a year. Suggests that the limitation be stated in terms of restriction on amounts set aside on tax deferred basis to provide a pension for any one individual; once the vested amount set aside equals the limit, any future vesting of contributions or earnings on the account would be currently taxable. Urges that, if across-the-board limitations seem unacceptable, then limitations be imposed wherever contributions on behalf of low-income persons is less than half the total contributions under the plan.

Maintains that substantial benefits for high-income persons are particularly disturbing when half of the work force does not receive any private pension benefits and those people, largely lower-income peo-

ple, are required to make up revenue losses incurred to give extra benefits to higher-income persons.

Vesting

Maintains that, if goal is relatively universal coverage by the private retirement system, the period of service required before vesting should be short enough to make it likely than any employee with average experience in changing jobs will earn vested benefits for at least a substantial portion of his working career. Tends to favor the Senate Labor Committee's approach—30 percent vesting after 8 years, increasing 10 percent a year to reach full vesting at 15 years. Urges shorter vesting periods in owner-dominated plans because the owner himself is "immediately vested in his benefit by the fact that he controls the business and thus is virtually certain to remain employed while the business is in existence."

Funding

Since crisis as to security of retirement benefits arises only on termination of plan, is reluctant to recommend mandatory increases in funding for all plans, just because a few terminate. Also, urges that present arrangement is undesirable in placing on the employees the burden of default on termination. Maintains that if the private retirement system is to fulfill the role of working in tandem with Social Security to assure adequate retirement income, employees must be able to count on it. Supports approach under which some basic amount is covered through insurance and remainder becomes obligation of the employer. Favors Senate Labor Committee proposal on this point.

Suggests that retirement plans be required to provide security first and profit-sharing benefits only after appropriate level of security is provided. Urges requirement of diversification in investments of plan. Indicates that, as to fiduciary requirements, the section 4941 private foundations self-dealing approach is desirable. Notes that this approach indicates that Internal Revenue Service can use enforcement tools other than denial of tax-exempt status. Urges this as another reason why pension reform should be handled through tax system, at least where tax benefits are given to pension plans.

Lump-sum distributions

Maintains that the purpose of the private pension program—encouraging savings for retirement—is defeated by lump-sum distributions; consequently, present law which grants special favorable tax benefits to such distributions exaggerates this defect and so should be replaced by provisions which prohibit or discourage such distributions.

Contributory plans; self-funded plans; self-employed

Indicates that for lower-income persons, contributory plans are contrary to the justification for tax benefits for private retirement programs, especially if the contributions are voluntary, because they make it less likely that employers and higher-income persons will see that adequate retirement benefits are provided to lower income persons.

Maintains that increasing available deductions on behalf of the self-

employed also benefits high income professionals without doing very much for the great majority of workers.

Maintains that self-funded plans are not proper approach to increase coverage of private pension system since it is likely that most of those who set up such plans are apt to have higher incomes. Cites experience of Canada which, in 1969 (12 years after the adoption of the program) had only 1.2 percent of persons earning less than $10,000 a year showing contributions to self-funded plans while over 35 percent of persons earning more than $25,000 were participating.

Integration with Social Security

Maintains that, since objective of the tax benefits for such plans is provision for retirement needs of lower income persons, urges that integration with Social Security should not be permtted to result in exclusion from plan benefits, until combined Social Security and private plan benefits reach prescribed levels of adequacy.

Estate tax

Maintains that value of pension benefits should be includible in taxable estates.

Professor Dan M. McGill, University of Pennsylvania, Philadelphia, Pa. (Panel No. 7):

Characterizes himself as a strong advocate of private pensions who disagrees with those who believe that private pension plans are a "'cruel hoax' perpetrated on an unsuspecting labor force." In support of his position that most plans are operated in a responsible manner, notes that one-half of all nonagricultural private employees are now covered under plans which have accumulated assets of $150 billion; that five million retired workers are receiving $8 billion annually in benefits; and that the great majority of plans provide for vesting after not more than fifteen years of employment. Believes, nonetheless, that certain areas should be regulated by statute, including vesting, funding, and plan termination insurance.

Vesting

Recommends vesting not only as a matter of equity and because of the difficulty of explaining nonvesting to employees, but especially because of the social role which private pensions serve in supplementing relatively meager Social Security benefits. Sets out eight principles which should be embodied in a statutory scheme of mandatory vesting:

(1) The legislation should apply to all types of plans—corporate, union, State, and local; funded and unfunded; and collectively bargained as well as single employer plans.

(2) Time of vesting should encompass age and length of service, based preferably on the Rule of 50 (under which vesting occurs when the sum of the employee's attained age and years of service with the employer equals fifty), coupled with a pre-vesting period of three years, reduced perhaps to two years for new employees over the age of thirty-five, and one year for employees over the age of forty-five. Concedes, however, that there is strong support for ten-year vesting and anticipates an eventual requirement of only five years.

(3) Employment with a given employer both before and after the

enactment of vesting legislation should be taken into account in determining eligibility and also, if possible, the amount of vested benefits; however, to permit wage adjustments which would offset the higher cost of mandatory vesting, the effective date of the legislation should be deferred for three years.

(4) There should be an upper limit on the monthly pension income required to be vested in order to avoid costs in excess of those required to provide a modest retirement income, taking Social Security payments into account.

(5) Cash withdrawals should be prohibited with benefits paid only in installments commencing at retirement age.

(6) Each employee should be given an annual statement as to his retirement benefits, as well as a termination certificate setting out his vested benefits and how to claim them when he reaches retirement age.

(7) Vested benefits should be preserved and protected either by the deferred claim approach or by the purchase of annuities from life insurance companies; transferring credits and associated assets to a successor plan, while appropriate to certain governmental units on a reciprocity basis, is too complex actuarially to be feasible in the private sector.

(8) Vested benefits ultimately payable to a terminating employee should be fixed in amount at the time he terminates.

Portability

Recognizes that the concept of portability has great political and emotional appeal, but warns that it is subject to many interpretations, particularly the extent to which an employee's accumulated pension benefits from previous employers should be adjusted upward to reflect subsequent events, including rising prices, expanding productivity, and changes in salary base and benefit formulas. Technically, portability is merely one method of implementing mandatory vesting, coupled either with reciprocity agreements among employers or the transfer of vested benefits to a successor plan, a central agency, or a life insurance company. As a practical matter, the preservation of vested benefits should be confined to transfers to insurance companies, although the deferred claim approach is also suitable if the employer's plan is adequately funded. Mentions the desirability of devising procedures which would protect the purchasing power of vested benefits, especially if payments will be long deferred.

Funding

Recommends that funding standards applicable to all plans should be imposed by law with periodic certifications of compliance by actuaries accredited for that purpose by an appropriate Government agency. While normal costs should be funded currently, more latitude is possible with respect to initial unfunded liability and other supplemental costs, which can safely be amortized over thirty or even forty years. Although multiemployer plans would strongly resist mandatory funding standards requiring amortization of supplemental costs, many of these plans are in precarious financial condition and such standards are essential to the protection of their participants (about one-third of the total employees covered by private plans).

Termination Insurance

While the percentage of plans terminated is very small, the consequences to individual victims are often tragic. Urges, accordingly, that a program of termination insurance be instituted, at small added cost, for both multiemployer and single employer plans, with appropriate premium differentials. Initially, at least, such insurance should be limited to plans covering more than 25 employees and therefore subject to the Federal Welfare and Pension Plan Disclosure Act; while this limitation would exclude 95 percent of private plans, it would include 95 percent of private plan participants. Safeguards against fraudulent terminations are necessary even with respect to these larger plans, but insurance abuses would be less likely.

Suggests that termination insurance be limited to vested benefits or perhaps only the mandatory portion thereof, with a dollar maximum expressed in terms of a multiple of Social Security benefits (not less than 1 nor greater than 2). Losses to participants resulting from insufficient assets should be covered whether the resulting termination is partial or complete. Stresses that termination insurance is not feasible unless coupled with contingent liability on the part of the employer to repay the insuror out of subsequent profits over an ensuing 20-year period, with the insuror's claim being subordinate to claims of general creditors.

Also discusses methods of financing termination insurance, including Government loans on a temporary basis; various bases for computing premium rates, including comparisons with the ten years' experience of Sweden and Finland; and modifications applicable to multiemployer plans.

Converse Murdoch, Murdoch, Longobardi, Schwartz & Walsh, Wilmington, Delaware (Panel No. 7):

Need for a fair system

Believes that tax reform is being discussed at all levels in America, with one recurring theme—the need to have a fair system. Believes there is a spread of tax cheating by rank and file citizens, due to complicated laws and a feeling that the system is unfair. Maintains that there will be more petty tax cheating unless the system becomes simpler and more fair.

The tax burdens on earned income

Considers that taxpayers who receive earned income are less favored by the tax laws than those who live on inherited wealth. States that present tax laws put an additional hurdle in the way of self-employed who wish to achieve a modest level of financial security, through the limitation on the maximum deduction for contributions to Keogh pension plans. Notes that present Keogh plan law does not allow a carryover of unused deductions, and does not allow greater deductions to persons with few remaining earning years.

Asserts that more people resent tax laws that seem designed to widen the financial gap between recipients of earned and unearned income. Lists ways that recipients of unearned income can decrease their taxes. Says the answer is not to take away existing tax benefits but to enable persons living on earned income to establish a meaningful retirement plan.

Says that tax breaks for deferred compensation items involve limited tax benefits for savings, which should be encouraged in a time of inflation.

Special problems of the self-employed

Considers that the self-employed, or person working for a small or closely-held business, faces special financial problems because his income is likely to stop if the principal owner of the business is disabled or dies. Contrasts this situation with the relative financial security of a person who works for a large organization.

Believes there is discrimination against the self-employed because there is an unreasonably low ceiling on deductible contributions to retirement plans (10 percent of earnings to a maximum of $2,500 per year).

Believes there is tax discrimination in the rule that places Keogh plan contribution limits on pension and profit sharing plans of Subchapter S corporations. Feels this has discouraged small business from electing Subchapter S status. Urges the committee to recommend the repeal of this rule.

Professional corporations

Believes that professional corporations have gained wide acceptance. Also believes that these corporations allow professionals an opportunity to use their own income to provide financial security for themselves, in a way that has been enjoyed for years by those employed by government and corporations.

Deductions for employee contributions under deferred compensation plans

Supports the administration proposals for limited deductions for voluntary contributions under retirement plans. Hopes that revenue estimators will not assume that a sizeable number of taxpayers will deduct the maximum. Favors allowing individuals to set aside before taxes enough money to provide a reasonable income at age 65, and favors allowing this amount to be set aside at a pace chosen by the individual. Believes this would aid the person who cannot start saving until late in life.

Concludes that fair tax treatment for persons living on earned income includes considerable relaxation of the tax rules applicable in the deferred compensation area, particularly for self-employed and those associated with small and closely-held businesses.

In response to inquiries also made the following comments:

Vesting.—States that in Delaware most of the small employer plans provide 100 percent vesting after 5 years of employment. Also states that most districts of the Internal Revenue Service have different vesting rules which must be met before a plan is approved as qualified.

Enforcement.—Believes the tax law is not the proper vehicle for enforcing vesting, funding, insurance, and portability. Does not favor self-dealing penalty taxes in the pension area such as exist in the private foundation area; believes these penalties are too strong.

Effects of Changes in laws.— Suspects that changes that increase the cost of qualified plans will result in larger employers moving to-

wards nonqualified, nonfunded deferred compensation plans for executives. However, believes that such changes would have a neutral effect on smaller employers because they must offer a qualified plan to meet competition.

Estate tax exclusion.—Justifies estate tax exclusion for qualified plans as a way to equalize situations between taxpayers with wealth that can be transferred during their lifetime and taxpayers whose wealth can only be transferred at death.

PANEL NO. 8—AN ALTERNATIVE TO TAX-EXEMPT STATE AND LOCAL BONDS

Mayor John D. Driggs, Phoenix, Arizona:

General position

Supports the subsidized taxable bond option as an addition to the existing tax-exempt mechanism. States that the Federally subsidized interest option is of interest because of the rapid growth in demand for capital funds by State and local governments. Believes that it will expand the supply of capital funds to local governments, and the taxable option should provide an access to the capital market for communities which now find extreme difficulty in the tax-exempt market.

States that the tax-exempt market must remain available as an alternative method of financing to protect the independence of local government decision-making.

Points out that there has been an evolution in the thinking of mayors since 1969 that was shown by the unanimous acceptance of a resolution in favor of a subsidized taxable bond option by the Resolutions Committee at the Indianapolis meeting of the National League of Cities. (One year before, the same resolution got nowhere in the same committee.)

The subsidy mechanism

States that the subsidy of interest costs must enable the bonds to compete on the general market and should not be subject to the appropriation process nor should the subsidy amounts be limited annually. Indicates that if either of those two prevailed, the Federal Government would be setting policies and priorities which would impinge on local decision-making.

States that the subsidy rate should be fixed and not flexible since, otherwise, it would be tampering with the marketability of the bonds, thus influencing local decisions on financing methods and creating tremendous uncertainty among the borrowers and lenders who constitute the market.

Suggests that the initial legislation should start with a relatively small subsidy to test the market's response to the new security.

Criteria taxable bond option must meet

States that the National League of Cities has outlined certain criteria that must be met to assure a taxable bond option:

(1) Cities must be assured protection of their independence and freedom from fiscal and other policy domination by the Federal and State governments.

(2) Cities should be able to retain at least as much financial advantage as they have presently with tax-exempt issues.

(3) The new financial mechanism must be automatic, irrevocable and enforceable in a court of law.

(4) Governments must be free to choose to issue tax-exempt or taxable issues, and the tax-exempt option must remain available.

(5) The administration of taxable bonds must not delay bond issues in ways that would jeopardize the ability of the user to gain maximum financial advantage in financing costs.

Net cost to the Federal Government

States that the Federal Government could achieve a zero cost position with respect to subsidy expenditures and tax receipts on the interest payments; however, it is not clear yet what percentage subsidy of the taxable rate of interest will produce that result.

Capacity of tax-exempt market

Indicates that there is growing doubt that the tax-exempt bond market will expand its capacity to meet at reasonable rates of interest growing municipal needs for new programs in public health, housing, urban renewal, transportation and environmental needs. Points out that commercial banks—the major holders of tax-exempts—tend to invest excess funds in municipal bonds, that is, after they meet the needs of business. Suggests investors who gain little or nothing from tax exemption may be interested in taxable municipals issued at rates competitive with other taxable securities.

Points out that outstanding State and local bond issues have increased from $94 billion in 1969 to $154 billion in 1971 and that present estimates suggest that new issues totalling over $50 billion will be required to finance immediate capital requirements in 1975.

Money Market Considerations

Believes that the taxable bond option would alleviate undue strain on the conventional municipal bond market when tight money prevails, and it would create a class of securities of interest to institutions that derive little or no advantage from tax exemption. States that competing in the taxable bond market should not work adversely on the municipal issues.

Industrial development bonds

Agrees that the subsidized, taxable bond option should not be available to industrial development bonds.

Harvey Galper, The Urban Institute, Washington, D.C. (Panel No. 8):

General

States that taxable bonds should be only an optional alternative of State and local governments in order to insure the continued existence of an exempt bond market to which local governments could return if the need arose. For the same reason, any Federal subsidy should not be so high as to terminate entirely the exempt bond market.

Believes that a fixed, inflexible subsidy rate would counteract the tendency of State and local bond interest rates to rise more rapidly than general interest rates in tight money markets, and to fall more rapidly than general interest rates in an easier credit market. Also,

the uncertainty resulting from a flexible subsidy rate would be disruptive to the market.

Points out that the basic benefit to State and local governments of a Federal subsidy would be to decrease their borrowing costs (the interest they pay on their bonds) rather than to increase the amounts of debt issue which lenders would take, for the amounts of debt outstanding would not rise dramatically even if the subsidy were set at 50 percent of the interest paid. States that the primary change in the outstanding debt would be from an exempt to a taxable character, particularly if the Federal subsidy should exceed 48 percent, for at that point commercial banks and fire and casualty insurance companies, which are normally taxed at that rate, would have no further reason to prefer tax-exempt bonds.

States that despite the increase in revenues that would result from taxing State and local bonds, the net cost to the Federal Treasury would increase according to the rate at which the Federal subsidy were set, and in fact would increase more rapidly geometrically (that is, in the percentage of the increase) than would any increase in the subsidy rate. Indicates that this would also be the result in the net income flow reduction of the investor in exempt bonds, in comparison to the ascending percentage of interest at which the subsidy might be set, despite the fact that his capital gain resulting from his holding of exempt bonds would increase as fewer exempt bonds would be issued.

Believes that little gain in eliminating the tax loophole would be achieved by setting the subsidy above 48 percent since most present investors in exempt bonds would switch to taxable bonds at least by that point. Furthermore, beyond that point net Treasury costs would rise more quickly because few other investors would be switching into taxable debt. Yet the increase in subsidy payments would be greater because there would be progressively larger total issues of taxable bonds outstanding on which subsidies would have to be paid.

Believes that some investors, such as commercial banks, might prefer to switch to taxable bonds before an exact breakeven point is reached. In addition, the market in exempt long-term bonds might be eliminated even while investors still might be willing to buy short-term exempt bonds. Resultingly, the recommendable Federal subsidy would be in the 40–45 percent range.

Net cost to Federal Government

States that if we assume that the subsidy rate is 40 percent, then tax exempts would continue to be attractive to taxpayers who are in the 40 percent tax rate bracket and above. Although the taxable bond option leaves tax exempt bonds available in the market which are attractive to high rate taxpayers, those people who continue to purchase tax exempts will find that the yield they receive will be lower than it was before the existence of taxable bonds. This is because the tax exempt bond market will be thinner, and the average yield on tax exempts will have been reduced. Therefore, the person who buys tax exempt bonds will have tax-exempt interest income, but he will be receiving a smaller amount of such income per $1,000 of investment than he did before the taxable bond option was available. The effect generally upon the net cost to the Treasury is that a smaller amount of money will be escaping taxation through tax-exempt bonds.

Believes that the annual net cost to the Treasury in the first few years with a 40 percent subsidy would be approximately $50 million. After a five-year period this would place the annual subsidy cost at approximately $250 million. Believes that after a period of ten or so years, the annual subsidy costs given present price levels would level off at approximately $600 million a year.

Indicates that to the extent that taxable bonds displace existing taxable issues in the taxable bond market, there will be no net cost to the Treasury because the total amount of taxable bonds marketed will remain unchanged. If the issue of taxable bonds by municipal governments also involves a shift of some funds from the tax-exempt bond market to the taxable bond market, there will be a net increase in revenue to the Treasury because a larger amount of money will be purchasing taxable bonds, and the total amount of interest earned on the taxable bonds and therefore taxable by the Federal Government will be greater.

Equity considerations

States that the taxable bond option is a compromise between eliminating tax-exemption completely and maintaining the status quo. It will reduce the amount of tax saving available to the people who continue to buy tax-exempts because we expect the rate of return on such issues to be less. The new option provides considerable savings to State and local governments, which is a desirable feature, since it is also the major objective of having such a choice available to the State and local governments.

Expansion of market for municipal bonds

Points out that the advantage of a taxable bond option is that State and local governments will be able to compete in a much broader capital market than they have in the past. The tax-exempt market is a very narrow market with a small number of participants. In the taxable bond market, there are a great variety of institutions which are interested in investing in such bonds. These institutions include the public and private pension funds, life insurance companies, and other types of financial institutions. Under the present situation, the market for tax-exempt bonds consists primarily of commercial banks which take between three-quarters and four-fifths of the issues, households which contain wealthy individuals who are seeking lower taxes, and certain financial institutions—most of which tend to be casualty insurance companies.

Assurance of permanency

Points out that if it is true that one Congress cannot bind another and that a subsequent Congress could completely eliminate the taxable bond option, then the only assurance would lie in the sense of responsibility of Congress. Suggests that the closest analogy is continuation of payment by the Federal Government of the interest due on the Federal debt.

Marketability of taxable bonds

Does not believe that the question of whether taxable municipal bonds can compete effectively in the taxable bond market implies a necessarily serious problem. The issuing governments will always

have the alternative of entering the taxable bond market or the tax-exempt bond market. As far as the Federal government is concerned, does not see how it can be worse off, because there already is available the tax-exempt bond as a tax avoidance device which costs more money than the implicit subsidy to the local governments. The taxable bond option—to the extent that it will be used—would reduce the net cost to the Treasury.

Believes that the new taxable bonds issued by State and local governments will be financed partly by funds which formerly were used to purchase bonds in the tax-exempt market. In other words, some of the people who will find that there are fewer tax-exempt bonds available and that their interest return is bid down will shift to the taxable bond market and accept whatever net loss there is after taxes. Another part of the financing of the new taxable bond issues may come from displacing other taxable securities which already are raised in the taxable bond market. Estimates that the displacement will affect approximately $1 billion of such taxable securities and agrees with Dr. Morris' estimate of this. This estimate is based on an assumption of a 40 percent subsidy of the interest cost.

Subsidy techniques

States that the simplest procedure would call for the Federal Government to make its subsidy payments directly to the governments which issued the bonds. Those governments then could make full payment on the coupons covering both the Federal Government's share and their own share.

Comparison with urban development bank proposal

Almost all of the urban development bank proposals call for the Federal agency to buy State or municipal government issues if they meet various specific criteria. If the local governments do not choose, or are not able, to meet these criteria, then the financing institution is under no obligation to purchase their issues. This approach involves the new agency in the decision-making processes of State and local governments. The advantage of the taxable bond option is that it involves no interference by a Federal Government agency in State and local government decisions. The subsidy is made available at a certain percentage of the rate of interest at which the State and local government can market the new issue. These governments make the choice of using the taxable bond option, and the Federal Government does not become involved in any way in the decision-making of the local government about whether it wants to issue a tax-exempt bond or taxable bond or for what purpose the proceeds from the bond issue will be used.

Use of funds by local government

One advantage of this plan is that it leaves State and local governments entirely free to decide how to use the funds they would raise with the taxable bonds. As things stand now, the proceeds from taxable bonds may be used to finance pollution control programs, housing programs, or programs involving any other social purpose which the local government considers would be desirable. It is possible that Congress may want to impose restrictions on the use of these taxable

bonds and leave the tax-exempt bonds available as the route for financing the restricted types of activity.

Frank E. Morris, President, Federal Reserve Bank of Boston, Boston, Massachusetts (Panel No. 8):

States that a taxable market for municipal bonds with a Federal subsidy would broaden the market for municipal bonds while reducing the tax inequity which stems from tax-exempt bonds. An additional benefit to State and local governments would lie in the reduction of the interest rates they would have to pay on tax-exempt bonds if there were not a taxable bond market.

Indicates that the net cost to the Treasury is uncertain, and would depend upon the tax brackets of the buyers of the taxable nonmunicipal securities that, except for the existence of the new market in taxable municipal bonds, would have been purchased by such tax-exempt buyers as pension funds, which have had no reason in the past to purchase tax-exempt bonds. The Treasury would break even on the subsidy if the tax rates of those buyers should be about 40 percent.

States that even if those tax brackets averaged only 35 percent, however, the ratio of benefit to local governments to cost to the Federal Government would be about four to one.

Believes that if the subsidy were set at 33 percent, there would be no net cost to the Treasury. The municipal bond market would be broadened in tight money periods only. Taxable bonds would be marketable primarily for long-term maturity issues.

States that with a 40-percent subsidy rate, the market for municipal bonds would be much more substantially broadened, and there would be a decline in the interest rates of tax-exempt bonds. Taxable bonds would dominate in tight money markets. There would be a cost to the Treasury.

Believes that a 50-percent subsidy would provide a great proportion of benefit to local governments as compared to Federal cost, but the tax-exempt bond market would be eliminated, causing disruption of the overall capital market. Thus, a 40-percent subsidy is recommendable for the present.

If State and local governments are to be provided with sources for borrowing, the market for municipal bonds must be expanded, for commercial banks, which have been the primary purchaser of municipal bonds, will not be able, for a variety of reasons, to continue to act in that capacity.

Asserts that the dual coupon system should not be used in a Federal subsidy procedure, and that the Federal payment should be a check from the Treasury to the bond issuer.

Confirms that it is now impossible to determine the exact amounts of benefits to State and local governments and, especially, costs to the Treasury resulting from a Federal subsidy, but can promise that the local benefits would be a multiple of the Federal cost.

Explains that inauguration of a 40-percent subsidy would mean that rates of tax-exempt bonds could never go over 60 percent of rates on taxable bonds, whereas, under present system, there is no limitation upon how high rates of tax-exempt bonds might go in tight money markets.

Points out that municipalities would still have tax-exempt market if Congress should refuse to continue funding a subsidy.

Would prefer the exclusion of arbitrage bonds from the subsidy.

Claims appropriations for a Federal subsidy could be made on the basis of an estimate of annual costs by the Treasury.

Proposes that the net cost under a 40-percent subsidy to the Treasury, after including in the computation the additional revenues arising from the taxable bonds, would be approximately $50 million annually. Confirms his figures do not assume a running loss of revenue from loss of investments in other taxable securities.

Argues that high-income taxpayers might continue to buy tax-exempt bonds but would receive a smaller yield under a Federal subsidy system.

Asserts that commercial banks will be unable to continue buying exempt bonds at the past pace not primarily because of the investment credit, but rather because their aggressiveness in switching into the exempt bond market during the 1950's was a "one-shot deal."

Wallace O. Sellers, Merrill Lynch, Pierce, Fenner & Smith, Inc., New York (Panel No. 8):

Ratios of interest cost by maturity of State local bonds

States that municipal bonds are different from most taxable bonds because of the serial nature of their maturities, rather than becoming due to entirety at the end. Notes that the yield curve of tax-exempt bonds has been steeper than that of taxable bonds; this means that tax exemtion provides proportionately greater benefits to the governmental borrower as the life of the bond is shorter. Indicates that short-term municipals sell at relatively better yields because of (1) major interest of banks in the shorter maturities; (2) the greater certainty as to the value of tax exemption in the near term; and (3) the smaller market risk factor in the short-term loans.

Believes that with the establishment of a municipal taxable bond option, the municipal bond yield curve (for both taxable and tax-exempt bonds) should flatten, taking on the same shape as the regular taxable bond curve (but at a lower rate) beyond the point where the interest subsidy becomes effective.

Use of the taxable bond option

Indicates that the degree to which the option is used would depend jointly on what would have been the ratio of rates between tax-exempt and taxable obligations in its absence and on the level of the subsidy. The ratio of rates has been related to maturities: the ratio for 10-year maturity tax-exempt issues has fluctuated between 60 and 70 percent of taxable rates; the ratio of 20-year maturities has been between about 68 to 76 percent; the ratio of 30-year maturities has been between 70 and 78 percent; whereas the ratio for short-term issues has been between about 55 and 60 percent. Thus, the long-term bonds would be the most likely user of the subsidy option. Considers stabilizing feature and the intermeshing of the two markets, which permits issuers to hit the lowest interest rates where they appear, to be very desirable features of the option.

Rate of Federal interest subsidy

Contends that the effectiveness of the taxable bond option depends heavily on the rate of Federal subsidy: for example, a 25-percent rate would be too low and of little encouragement to use the option; and a 50-percent rate would, in effect, be a backdoor form of revenue sharing which would tend to induce all States and localities to use the Federally subsidized borrowing and thus destroy the tax-exempt market. Feels that 33⅓ percent rate would reflect a favorable relationship between taxable and tax-exempt yields in the area of greatest use of bonds. Maintains that if the Federal Government were to subsidize all State and local bonds, this would result in higher interest rates for other taxable bonds.

Types of bonds most likely to take taxable route

Given a one-third subsidy rate, projects that the maturities that average in excess of 20 years represent the prime candidates for the taxable bond option. As credit conditions tighten, shorter-term bonds would also find the taxable option attractive.

Fixed subsidy rate

Asserts that the subsidy rate should be fixed to avoid the problems of discretionary use of an uncertain subsidy rate and its possible abuses. Any governmental unit now eligible to issue a tax-exempt bond should be able to utilize the taxable option, with no strings attached. The subsidy should be paid on the annual interest payment, in semi-annual installments. In the case of bonds sold at a premium, the borrower should at the time of the sale return an appropriate share of the premium to the Treasury. On the other hand, believes that no adjustment is necessary where bonds are sold at a discount—a very rare occurrence in municipals.

Self-dealing provision

To protect against possible self-dealing in the issuance of bonds between affiliated governmental units (such as issuing a high interest rate bond to fund a pension plan), suggests that the legislation might require that all taxable bonds must be publicly offered and sold at competitive bids unless the issuer gets a waiver from Treasury.

Permanent appropriation

Maintains that the subsidy plan should not be subject to the annual appropriations process with the possibility of abrupt changes or repeal. States that a requirement of a five-year termination notice before the program could be phased out would be a useful safeguard.

Tax-exempt interest and the minimum tax

Argues that inclusion of tax-exempt interest in the minimum tax preference base would disrupt the tax-exempt market and offset the option benefits.

Other comments

Recommends that the taxable option not apply to industrial development revenue bonds because the Federal Government would be lending its credit to private corporations.

PANEL NO. 9—NATURAL RESOURCES

Richard J. Gonzalez, Houston, Texas:

States that the paramount economic test of a system of taxation is that it should interfere as little as possible with the industrial progress that enables the entire population to enjoy the benefits of rising standards of living, and that to insure increasing supplies of capital and minerals, Congress must be concerned about the appropriate taxation of capital and minerals. Labor income taxed in the same year as earned income requires no adjustment for changing dollar values, but the true earnings on capital can be determined only by proper adjustments for the changing purchasing power of the dollar during and after periods of marked inflation.

Points out that several major aspects of mineral operations cause it to differ from most other investments and that these are: (1) exploration and development carries unusual risks as is reflected by the large number and high cost of unsuccessful ventures; (2) long-lead time before initial operation is followed by exceptionally long life for very successful ventures. (These are the principal attractions and rewards for engaging in this risky business); (3) revenues are realized by the depletion of nonrenewable resources rather than by the sale of products made by utilization of renewable capital assets; (4) mineral producing operations are highly capital intensive. Suggests that these differences are the economic basis for appropriate tax differentials essential to fair treatment of investors in this business.

Accounting deficiencies in measurement of income

Suggests that to the extent that accounting practices provide incorrect impressions of real economic income, they can be highly misleading as to the proper base to which ordinary tax rates should apply. States that one example of this is the accounting practice of recording the costs of dry holes as a capital investment in financial reports and then in accordance with the tax laws, to deduct currently the cost of dry holes. Adds that another example, and one which is more important regarding misleading appearances, is the fact that the sale of minerals involves depletion of reserves acquired many years earlier when the value of the dollar was much more than it is now. States that the relation of percentage depletion to market price compensates for inflation in ascertaining the correct economic income from petroleum production properly subject to taxation as ordinary income.

Points out that differentiation between ordinary income and capital gains is necessary and appropriate to provide equitable treatment of long-term capital gains and to avoid taxing capital.

Analysis of costs and benefits of tax differentials

Believes that tax differentials must be analyzed in relation to the cost and benefit of each differential over a period of time. Tax differentials should be analyzed not simply on the issue of revenues gained or

lost but the public benefits that will be forthcoming from these differentials. Suggests that short-term gains and tax revenues should be analyzed in relationship to the expense of long-run costs in terms of employment, national income, social welfare, economic security for consumers, and the strength of the United States to exert influence in international affairs.

Basic economic case for percentage depletion

Points out that wildcat petroleum exploration is extremely risky. Dry hole costs are very expensive. Suggests that productive wells, therefore, must return much more than their direct costs in order to cover total outlays on exploration and drilling. New exploratory efforts to develop oil and gas reserves on the continental shelf and in Alaska are extremely high in comparison to the cost of on-shore wells. Points out that, for example, the 884 offshore wells drilled in 1971 cost $522,617,000 for an average of $591,200 per well, compared with less than $77,000 for on-shore wells.

Suggests that the Tax Reform Act of 1969 had the effect of raising taxes on U.S. oil and gas producers by more than 4 percent of gross revenue. Suggests that this action was an important factor contributing to the 20 percent decline in drilling from 1969 to 1971.

Responds during the discussion as follows:

Percentage depletion

Responds to the question of whether mineral producers pay their proper share of income taxes by stating that most of the receipts from depletion of reserves by production are not ordinary income and, therefore, should not be taxed at ordinary rates principally because they are due to changes in the value of the dollar and consequently represent neither income nor capital gains.

Responds to the question of whether depletion should be allowed only in the case where the assumed tax savings are spent on further search for the same minerals, that to require successive exposure to the same risks in order to collect on past promises would be comparable to a gambling game in which winnings can never be withdrawn but must be risked repeatedly regardless of changing odds. States that a change allowing percentage depletion only to the extent that money is spent on new ventures would represent a change in the rules which could actually work to discourage rather than to encourage attraction of new capital.

Responds to the question of whether percentage depletion runs counter to conservation principles by encouraging excessive use of oil and gas through low prices, that he believes that percentage depletion encourages discovery and development of resources. Suggests that there can be no meaningful conservation program until resources can be found and developed.

Responds to the question of whether percentage depletion on foreign production divert efforts abroad, that he believes that funds will flow into the most attractive prospects when available either in the United States or abroad. Believes that percentage depletion is only one of several factors which affects the rate of return and investment decisions.

Expensing of intangible development costs

Suggests that changing the timing of tax payments by expensing intangible development costs rather than capitalizing them is extremely important to all operators especially the small operators and that disallowing the option to expense intangible development costs would drastically curtail small operators' abilities to raise more capital.

U.S. income tax treatment of foreign oil production

Suggests that critics relate U.S. income tax payments to worldwide income of oil companies without regard to the large income taxes these companies have paid to foreign countries and that these payments are not royalties because these foreign countries impose taxes in addition to the normal royalties. Believes that the reason no U.S. income taxes are paid on foreign-production is that even higher foreign income taxes have already been paid. Suggests that if the U.S. tax laws were changed such that there were discriminatory changes regarding the foreign tax credit, this would discourage foreign oil operations by U.S. companies and would work to the advantage of firms based in other countries without any gains to the U.S. Treasury or to the U.S. citizen.

Additional tax considerations

Believes that a rational decision regarding income taxes in the petroleum industry should not be made without regard to the variety of taxes levied on petroleum throughout the entire economy.

Summary views on petroleum taxation

Believes that the changes made in 1969 were in the wrong direction and that imposition of greater taxes by further reduction of percentage depletion or requiring capitalization of intangible development costs for tax purposes would work contrary to the Federal action needed to stimulate domestic discovery, development, and production.

Suggests that the uniform percentage depletion treatment of all minerals could be clarified by discarding the varying gross depletion rates in favor of the 50-percent of net revenue limitation. This uniform rate could be recognized as the minimum differential required for each property to protect the values liquidated by mineral production.

Professor J. Reid Hambrick, George Washington University Law School, Washington, D.C. (Panel No. 9):

Points out that the favorable tax advantages granted to the producing segment of the oil and gas industry include percentage depletion, the privilege of deducting, currently, intangible drilling and development costs, which constitute approximately 75 percent of the total cost of drilling and completion, investment tax credits and depreciation for tangible well equipment, and the foreign tax credit.

Percentage depletion

Points out that percentage depletion allows for the recovery of capitalized investment in producing oil and gas properties many times over and at the present 22 percent depletion rate, this allowance recovers the same dollar of capitalized costs about sixteen times over. Recommends that the present 22-percent rate be reduced to 17 per-

cent. At this lower rate, capital recovery would be about twelve times over. As an alternative, recommends that a reduction to 12 percent be initiated over a period of 4 years. As a second alternative, suggests that after percentage depletion has recovered capitalized investment in a producing property ten times over, no further deduction for depletion would be allowed.

Intangible drilling and development costs

States that the differentiation in the treatment of tangible equipment and the labor costs of installation, capitalizing the one but not the other, is irrational and inconsistent with modern tax and accounting principles. Suggests that if capitalized intangible development costs are recoverable only through the depletion allowance, percentage depletion should be adjusted in all cases where intangible development costs have been currently expensed, otherwise, duplicate deductions result. Recommends that percentage depletion should not be allowed in respect of production from any well until the gross income of the well equals the amount of intangible development costs attributable to the drill hole and claimed as current expense. Points out that percentage depletion duplicates and recovers the same costs that have been deducted as intangible development costs. By disallowing percentage depletion until the intangible development costs, which have been expensed, are equal to the gross income of the property, there is a withdrawal of the double benefit that is now allowed.

Points out that labor costs associated with the installation of tangible equipment in oil and gas wells are treated as intangible development costs and can be deducted currently. Urges that labor costs associated with equipment installation be capitalized to the cost of the new equipment.

Recommends that if the suggestion regarding treatment of intangible development costs and the capitalization of labor cost is adopted, then it would be appropriate to suggest that any person who bears the financial burden and risk of loss of intangible development costs should be entitled to the benefit.

Tangible well equipment

Points out that tangible well equipment is presently depreciated independently of percentage depletion and that the present practice of separating well equipment and the drill hole itself is another accounting anomoly. Recommends that the costs of tangible materials and equipment installed in oil and gas wells and not within the option permitted with respect to intangible development costs including labor costs of installation must be capitalized and recovered only through the depletion allowance. Additionally, the definition of investment credit property should be amended to exclude tangible well equipment.

Foreign tax credit

Suggests that the foreign tax credit provisions be amended to exclude from the categories of creditable taxes amounts paid to a foreign country in the form of income taxes pursuant to the terms of a mineral concession granting mineral exploitation rights or amounts which are determined to be in substance and effect in lieu of royalties, net profits

or other amounts. Suggests, in essence, treat so-called income taxes paid to foreign lessor countries as a royalty or net profits payable, exclude such amounts from the operating company's gross income for depletion, and disallow such taxes as foreign tax credits.

States that the problem of high foreign prices was caused by the existence of an international cartel. Believes that the U.S. should maximize its efforts to break up the cartel by putting pressure on the member companies.

John G. McLean, Continental Oil Company, Stanford, Connecticut (Panel No. 9):

The energy crisis

States that the U.S. faces a serious medium term energy problem and that energy requirements will double between now and the middle 1980's and most of these requirements must be met through the use of oil, gas, coal and nuclear power. Believes that we will become increasingly dependent upon foreign countries, especially the 11 OPEC countries, for our energy supplies. Oil and gas imports will result in a substantial balance of trade deficit. OPEC countries, on the other hand, will become new centers of financial power, which may not be desirable due to their inexperience in international monetary matters. Finally, scarcity of energy supplies will result in sharply rising energy costs.

To meet these problems, advocates the creation of a cabinet-level energy committee to create legislative, regulatory and economic circumstances to make it possible for private enterprise to develop energy resources. All possible steps should be taken to stimulate domestic development. We should permit the price of all fuels to reach competitive market levels. Import quotas should be maintained to prevent massive shifts in balance of trade. There should be reasonable modifications of ecological legislation which hinders the development of indigenous fuels. We should initiate national programs to conserve energy. We should also begin work on research and development programs to take care of our long-term energy needs.

Tax incentives, coupled with moderate price increases, are an important means of stimulating domestic energy development. Percentage depletion should be restored to the 27½ percent level and should be removed from the list of minimum tax preferences. Percentage depletion is a particularly important tax incentive since it is success oriented. Also of vital importance in terms of raising capital are the provisions allowing the current deduction of intangible drilling and development costs. Further, the current tax treatment of foreign operations should be continued. The foreign tax credit is not a special tax advantage but merely means that the oil companies pay the higher of the U.S. or the foreign tax.

Oil import quotas

In the panel discussion, Mr. McLean questioned whether the energy problem could be solved by relaxing oil import quotas, because a number of industrial countries were competing for foreign oil supplies, and also because of the adverse impact which substantial imports would have on our balance of payments problem. He disputed statements of other panelists that prices of foreign oil were being main-

tained at artificially high levels by a cartel. He felt the best way to reduce the power of OPEC over prices was to develop a strong domestic oil program.

Other comments

Indicates, in response to a committee question, that alternatives such as solar power, geothermal power, the fusion reactor, and deevlopment of oil shale would help the long-term energy problem, but that lead time factors, capital inputs, and technological problems were such that little relief could be expected from these sources before the middle 1980's. However, development of domestic coal reserves and conventional nuclear power could be helpful in a shorter time frame.

States that reduction of tax incentives was bound to lead to an increase in consumer prices. Also, such reductions make it harder to attract risk capital because potential investors fear that the tax incentives for the industry might be reduced still further at a later date. Thinks proven incentives, such as percentage depletion, would probably be preferable to some new form of incentive, such as a tax credit for oil and gas exploration expenditures.

Willis B. Snell, Sutherland, Asbill & Brennan, Washington, D.C. (Panel No. 9):

Introduction

Indicates that his statement relates to the so-called hard minerals, that is, those other than oil and gas and discusses two subject areas relating to this industry: (1) percentage depletion and (2) exploration and development expenses.

The need for percentage depletion as an incentive to mineral exploration and investment

Believes that percentage depletion provides an incentive to the extractive industry to undertake the risks inherent in exploring for new deposits and that although not as widely publicized and realized, the same difficulties and uncertainties exist in finding suitable deposits of a number of hard minerals.

Points out that the development of a mine after discovery of the deposit and the construction of adequate processing facilities requires the expenditures of large sums because of the time lag, which may be several years, required for such development and construction. Suggests that the market and other conditions which justified the initial investment may have changed significantly so that the anticipated profits on which the decision was based are substantially reduced or eliminated. Points out that unfortunately, extensive data that are available in the oil and gas industry are not available in the hard minerals area.

Believes that tremendous reserves of coal are available but tax incentives are vitally needed to attract capital to this industry. Believes that low profit levels and marked cost increases, because of mine safety requirements, environmental protection measures, and many other factors, characterize this industry.

Recommendations as to legislative action

States that when considering proposals for repeal or reduction of percentage depletion, two matters must be kept in mind.

First, many investment and pricing decisions have been made on the basis of the existing allowance. Suggests that reduction or elimination now will necessarily result in either or both lower rates of return than were anticipated and which now exist or higher prices for purchasers of the minerals. Additionally, lower rates of return will discourage further investment in mining and higher prices will tend to create additional inflation.

Second, emphasizes that little statistical or other data are available to judge the actual effect of percentage depletion. States that it is not known to what extent percentage depletion has increased the after-tax income of the mining industry on the one hand, or reduced prices on the other.

Suggests that when considering the need for any further legislation dealing with percentage depletion, it should be kept in mind that this allowance was substantially reduced in three ways by the Tax Reform Act of 1969: First, the rates were reduced for most minerals; second, the tax treatment of mineral production payments was changed; third, the minimum tax was enacted and suggests that this change was the most significant.

In the absence of statistical or other data regarding the effect of a reduction in the percentage depletion rates, suggests that solutions are merely theoretical, cannot tell us what the effect of repeal would be on consumer prices, inflation, the balance of payments, or the future growth of the economy. Points out that without reliable data, reductions in the existing rates will be arbitrary and will pose a serious threat to the mining industry.

Recommendations.—Suggests that the present allowance should not be eliminated or reduced.

Minimum tax

Believes that the primary effect of the minimum tax may well be the reduction of percentage depletion. Points out that two corporations which have exactly the same gross and taxable income from mining are entitled to the same percentage depletion deduction and are otherwise entitled to exactly the same tax preferences. However, if one of these corporations has nonmining income in addition to its mining income, that corporation will pay less minimum tax than the nonintegrated mining company since the income tax paid on other income reduces or eliminates the minimum tax. Suggests that the benefit of percentage depletion is significantly less for independent miners, and integration and mergers of mining and nonmining companies will be encouraged. Points out that additional examples also bear out this theme.

Minimum tax recommendation.—Suggests that Congress should at this time revise the minimum tax insofar as it relates to corporations. Believes that such revision should consist of repeal of such tax as to corporations or elimination of percentage depletion as a preference item or converting the tax to a true minimum tax from the additional tax which it is today.

Exploration and development expenses

States that the income tax treatment of exploration and development expenses incurred in relation to hard minerals differs substantially from that provided for such expenses relating to oil and gas.

Points out that exploration expenses regarding the hard minerals area are, at the option of the taxpayer, deductible currently, subject to an overall dollar limitation per taxpayer as to foreign expenses, but these are subject to recapture when the mine reaches the producing stage or when the taxpayer disposes of the deposit before production. Additionally, development expenses are, at the option of the taxpayer, deductible currently in lieu of being capitalized and amortized over the expected life of the deposit.

Present incentive for exploration and development expenses

States that under current law, any incentive or preference provided for exploration and development expenses relates only to the timing of the deduction and that the treatment of these expenses is not different in principle from accelerated methods of depreciation or amortization since in both cases the existing policy of the tax is to encourage expenditures by permitting early deductions.

Recommendations as to legislative action

Recommends that the need to encourage exploration for and development of natural resources requires continuation of the present rules as to exploration and development expenses.

Also, suggests that consideration should be given to removal of the restrictions on the deduction of foreign exploration expenses in view of the desirability of encouraging domestically owned corporations to develop foreign sources of ores and minerals which are not available domestically.

Summary of recommendations

Urges that there be no reduction in the incentives provided to the mining industry by the present percentage depletion allowances and the tax treatment of exploration and development expenses and that consideration be given to eliminating the erosion of the percentage depletion deduction caused by the minimum tax (especially in the case of the nonintegrated independent mining company) and the present discriminatory treatment of foreign exploration expenses.

Oral testimony

In response to the question regarding the U.S. supply of the so-called hard minerals, states that available statistics indicate a large number of shortages in the hard mineral area today and by the year 2000, according to the Department of Interior, the U.S. will be in a deficit position with respect to 89 out of 90 commodities.

Professor Robert M. Spann, Virginia Polytechnic Institute and State University, Blacksburg, Virginia (Panel No. 9):

Justification for existing tax benefits

States that the existing tax provisions which are favorable to mineral extraction industries—percentage depletion allowance and expensing of intangible drilling and mine development costs—are results of purposeful goals by policymakers. The dominant justification for the tax benefits petroleum industry enjoys has been the so-called national security argument, which makes the claim that extra mineral resources are needed to cover the country's requirements in national emergencies. This argument presupposes that the special tax provi-

sions do in fact generate more reserves than would otherwise be the case. However, it is not clear whether our national security requires greater reserves than the market would generate without special tax provisions, or whether these provisions provide the least cost method to obtain additional reserves.

Evaluation of present tax policies

Points out in evaluating the effects of present tax policies, given the above goal, distribution and allocative effects of the existing tax benefits. Notes that the income distribution effects favor large users of petroleum products and increase real income of people who consume less than an average amount of those products because they pay either higher taxes or higher prices for what they consume as a result of tax provisions favorable to petroleum industry. The favorable tax treatment attracts more resources to petroleum industry than would otherwise be the case. From a strictly efficiency standpoint, this leads to a less efficient resource allocation and consequently a lower gross national product. Notes however, that this may or may not be socially desirable.

Conclusions

The effects of altering the current tax policies are evaluated using price of domestic output and the degree of U.S. dependence on foreign oil as critical variables. The primary conclusions of his study are:

(1) Elimination of the package of special tax provisions accorded the petroleum industry would, over the long run, increase crude oil prices by approximately 24 per cent, reduce domestic crude oil output and discoveries by approximately 10.5 per cent and reduce crude oil reserves held by about 24.4 per cent.

(2) Elimination of percentage depletion while retaining the expensing of intangibles would increase crude oil prices by about 9 per cent, reduce crude oil output by approximately 4.3 per cent, and reduce reserve holdings by about 11.2 per cent.

(3) Using 1971 as a base, the import ratio would have had to increase to about 37 per cent (from 14.6 per cent) in order to hold crude oil prices constant if the special tax provisions accorded the petroleum industry were not in force then. For the case in which only percentage depletion is eliminated, the required import ratio would have been 28.7 per cent in order to hold wellhead crude oil prices constant.

(4) The special tax provisions accorded the petroleum industry have significant costs. The tax revenue foregone due to these provisions is approximately $2.5 billion. The social cost of the tax provisions in terms of the misallocation of resources attributable to those provisions is about $.9 billion.

(5) There is evidence that the level of national security in terms of increased domestic reserves could be obtained more efficiently (at a lower cost) through alternative policies such as storage reserves.

In response to questioning, emphasized that the magnitudes estimated would result in the long run and that our increased dependence on oil imports would have to come about gradually. To the question how should the United States resolve the balance of payments prob-

lem which could arise as a result of higher imports of crude oil he commented that we would either have to revise our exchange rate, or we would have to export more. He offered no specific suggestions with respect to exports.

Professor Arthur W. Wright, University of Massachusetts, Amherst, Massachusetts (Panel No. 9):

Energy crisis

States that with respect to the alleged "energy crisis", in general we do not have a general energy crisis but rather man-made problems which have interfered with operation of markets. The offending policies are the oil import quota program, U.S. foreign policy towards the Organization of Petroleum Exporting Countries, and Federal Power Commission's natural gas price-setting practices. The first two policies are responsible for keeping prices of petroleum products too high through monopoly controls. The third policy is responsible for keeping gas prices too low, thereby creating a shortage of natural gas production. In addition, the Administration's Phase II price controls have affected business decisions so that temporary disruptions of supplies resulted.

Existing Federal tax policies and alternatives for solving energy crisis

(a) *Efficiency.*—In examining the effectiveness of the existing special Federal tax provisions which affect natural resources, concludes that efficiency would be served by letting market prices allocate energy goods. The special tax incentives for energy lead to inefficiency by causing over investment and over-production of energy goods. New tax incentives could be effective if they were used to include human and environmental costs in energy production and consumption decisions and to stimulate more research and development in energy.

(b) *Equity.*—With respect to equity, Professor Wright notes that the special tax incentives redistribute income from taxpayers and consumers of Government services to energy shareholders, and to consumers of energy goods. He notes that, if such a redistribution were desirable, other income redistribution policies are available which would be less inefficient.

(c) *National security.*—Defines the national security objective in energy as reduction of the sensitivity of the U.S. economy to sudden interruptions of energy supplies. This objective can be served either by reducing our current dependence on less "secure" foreign energy sources, or by stockpiling energy supplies for emergencies. Suggests that the present tax incentives do stimulate production of domestic oil, gas, and coal, but with sacrifices in both efficiency and equity. Suggests that the principal alternatives to present policies are (for oil) a plan which would rely solely on domestic sources of supply and would be very inefficient; a tariff oil import control plan which would be more efficient than the pure national security plan or the present oil import quotas; and a stockpiling plan which relies for regular supplies on cheap imported oil and which would be the most efficient national security plan of all. For natural gas, the regulation of price by Federa Power Commission would serve both the national security objective and efficiency by increased domestic gas reserves and output. Finally,

a crash program of additional research and development on coal production and use should be evaluated as a possible measure for promoting national security in energy.

Conclusions

Suggests that the existing special tax incentives, in balance, do not appear to be the best available choices of public policies. Elimination of these incentives would not aggravate energy problems and would increase efficiency and equity. He appears to believe strongly that free market action without government interference would be beneficial to all competitive energy markets. Paucity of empirical evidence hampers economic analysis on which to base final judgments.

In response to questioning, stated that the current high market prices of foreign crude oil resulted from policies set by the cartel of Organization of Petroleum Exporting Countries. Breaking up the cartel would lead to a competitive world market price of crude oil as contrasted to the present one which is set administratively by the cartel so as to maximize its profits. The oil producing countries own the cartel and get the profits, but the oil companies administer it.

Restated that he would wish the existing tax preferences removed so that the market would adjust the rates of return on capital and prices to consumers. Our present policies are creating gross inefficiencies in energy area and in the long run work out in a way that makes our exports less competitive. Moreover, once the existing tax preferences are removed, business decision-makers would be relieved of the uncertainty regarding changes in tax policies.

Our balance of payments position would depend largely on what happens to oil prices in world markets; even if our oil imports increased substantially, the balance need not worsen much from what it would otherwise be if the OPEC cartel is broken.

PANEL NO. 10—ESTATE AND GIFT TAX REVISION

Dr. Gerard M. Brannon, Georgetown University, Washington, D.C.:

Progressivity of tax

Observes that the estate and gift taxes are remarkably progressive taxes on accumulated savings and that these taxes are good in that they deal with the problem of income distribution at a time when it is less likely to interfere with economic incentives.

States that due to the narrowness of the tax base and the high rates, that the estate tax accounts for a much larger portion of the progressivity of our tax system than one would guess from the relatively small amount of total revenues it raises. Also, the estate tax base has grown faster than the gross national product, suggests that the estate tax exemptions be lowered rather than raised and suggests that the additional revenues be used to reduce the income taxes.

Capital gains tax at death

Believes that the biggest problem to be the treatment of capital gains at death. Suggests that the appreciation be made subject to tax as income prior to calculation of the estate tax. Points out that his proposal differs from prior proposals in that he would tax appreciation at death at ordinary rates with averaging. Believes that there is a gross inequity in that the present system applies both income and estate taxes to wealth accumulated from salarly, dividends, interest, and business profits, but only estate tax to wealth accumulated from unrealized appreciation. Views carryover basis as a completely unsatisfactory solution in that it prevents heirs from using the assets as they see fit without paying a penalty. Indicates that if capital gains were taxed at death, he would allow a carryback for capital loss.

Unification

Urges the full unification of gift and estate tax. States that the present incentive for lifetime giving rises dramatically with the size of the gift because the gift tax is not grossed up. States that any incentive for that type of giving should be limited to donees who have achieved majority and to gifts in which the donee receives current control of the property.

Generation-skipping

Recommends that a tax be imposed on transfers that skip generations. Suggests that this follow the general lines of the method in the *Treasury Tax Reform Studies and Proposals* which imposed a tax on both generation-skipping trusts and outright generation-skipping transfers.

Marital deduction

Indicates that an unlimited marital deduction would, in the short run, reduce Federal revenues by about 18 percent of the estate and gift tax yield and suggests a $100,000 limitation on such a deduction. Believes that in cases where the marital deduction is very large, that the extra tax when the spouse dies can be much higher than the tax saving at the first death. Believes that the marital deduction could be supplemented by a limited orphan's exemption. Believes also that the question of taxing insurance and employee benefits should be looked at with the marital deduction, you can increase the tax base.

Accessions tax

States that the Committee should consider whether it wants an estate tax. Suggests that the Committee might want to consider an accessions tax but feels the Committee should first consider the questions of unified gift and estate tax, marital transfers, generation-skipping, and capital gains at death which are basic issues whether you have an estate or inheritance tax.

Bart A. Brown, Jr., Dinsmore, Shohl, Coates & Deupree, Cincinnati, Ohio (Panel No. 10):

Claims unrealized capital gain should not be taxed at death because resulting liquidity problems could often not be solved. To treat death as a taxable event would impose a tax upon an involuntary occurrence.

Asserts that since estate taxation is now frequently based only upon estimated valuations of property, to require the use of such valuations for capital gains tax at death would compound possible inaccuracies.

States that since the proposed tax would be paid as a death tax by estates, rather than by the deceased persons themselves, individuals would still hold property until death to avoid personal taxation, and thus the "lock-in" problem would not be resolved. Serious personal hardships and administrative complexities would result from such a tax.

Proposes that a preferable alternative to a capital gains tax on unrealized appreciation at death would be carryover of the transferor's basis to the transferees, thus resulting only in a postponement of tax upon the appreciation. If this suggestion should be followed, the amount of estate tax paid should be added to the tax basis, and the basis should be allocated among the properties of the estate so that no transferee would receive an undue amount of untaxed appreciation. However, only property taxed for estate tax purposes should receive the benefit of an increased basis due to the estate tax.

Suggests that if the carryover basis alternative should be selected, liberalized rules for proving basis, including a grandfather clause for establishing basis according to fair market value as of a certain date, should be provided to obviate uncertainties as to the correct basis.

States that costs and administrative disadvantages of unifying inter vivos and testamentary (gift and estate) taxes into one tax outweigh the advantages. To do so would discourage gifts from the living,

which is a desirable social goal, since there would no longer be a tax advantage in such giving.

Argues that regardless of inequities not yet introduced, the present estate tax rate structure is inequitable, with rates increasing from 3 to 30 percent in the first $100,000 of an estate, but only to 57 percent for an additional increase of estates up to $3,500,000.

Claims the marital deduction should be expanded because to do so would tend to prevent property from being taxed more than once to one generation, and because this would accord with the understanding of most families that their property is family property. However, to prevent undue revenue loss, the allowable marital deduction could be the greater of $500,000 or one-half the adjusted gross estate.

Believes outright transfers of entire properties to any generation are generally not caused by "generation-skipping" motives, and hence should not be the occasion for an additional estate tax. An additional tax should be required, however, in transfers of split interests in property, whether made in trust or not, to transferees beyond the second generation (such as the grandchildren) below the donor.

Agrees an additional tax should also be imposed on generation-skipping transfers that give the intervening generation almost full ownership of the property.

Believes that many proposals for revising present estate tax rules would increase costs of dying and would make impossible the continuation of many family businesses.

Asserts that the amount of gift tax avoidance under present law is not substantial. Believes that the problems to taxpayers and the Government resulting from a unified tax system would outweight the revenues resulting from the minimal tax impact it would have. Maintains that present abuses could be avoided through minor changes in existing statutes.

Doubts that lowering the death tax rate would result in increased death tax revenues.

Claims that prolonging the time in which Federal death taxes must be paid would help alleviate the liquidity problem arising when properties must be sold to pay death taxes.

Marvin K. Collie, Vinson, Elkins, Searls, Connally & Smith, Houston, Texas (Panel No. 10):

Taxation of unrealized appreciation at death

Strongly opposes a tax at death on unrealized capital gains on the ground that the appreciation is, in fact, subject to the estate tax and that an additional tax would constitute double taxation, except as to assets passing tax-free under the marital or charitable deduction. Notes that a capital gain tax at death would greatly intensify liquidity problems and result in additional forced sales of family businesses, farms and ranches, and homestead property (which, under the Texas constitution, can be mortgaged only to secure the original purchase price or the cost of improvements). Also objects to the fact that proposals for taxing unrealized gain at death ignore the obverse problem of providing relief for unrealized losses at death.

Believes that during life each individual should choose for himself whether to sell or retain appreciated assets, with the potential

tax saving at death often outweighed by the non-tax advantages of an earlier sale—diversity, liquidity, larger income, and reduction of risk. If it is sound public policy to discourage long-term retention of property, then an income tax on unrealized appreciation should be levied periodically on all capital assets. Taxing capital gains at death also raises a parallel question with respect to the untaxed increment in life insurance policies.

Unified gift and estate tax

Urges that the present dual system be retained, not only to encourage lifetime gifts but to avoid the massive practical problem of reviewing and revising all current estate plans, trusts, and wills. From practical experience, it is to him apparent that younger persons employ capital more vigorously than their elders, a result which should be promoted not only by retaining the present lower gift tax rates but also by further limiting the investment and distribution restrictions which can be imposed by long term trusts.

Argues that proposals to eliminate present differentials in gift and estate tax rates and to "gross-up" *inter vivos* gifts would not neutralize lifetime versus testamentary transfers but would encourage the retention of property until death. Also points out that if lifetime gifts *were* made, a subsequent decline in the value of estate assets could result in a confiscatory estate tax since estate tax rates would begin not at zero but at the cumulative total value of all prior gifts.

Cautions that the imposition of a unified system, necessarily on a prospective basis, would create severe administrative problems, including (a) retention of the dual system for an indefinite period with respect to existing trusts and similar instruments; (b) additional burdens on the executor or administrator with respect to ascertaining *all* prior gifts in order to determine correct estate tax rates; and (c) re-coordination with State death tax systems.

Generation-skipping

Believes that the social objections to generation-skipping can best be eliminated by restricting the scope of powers of attorney. Notes that objections to generation-skipping are, in essence, philosophic resistance to the transmittal of substantial fortunes either in toto (which could be attacked more directly by the imposition of confiscatory estate tax rates) or to individual heirs and legatees (which could be more equitably adjusted by an accessions tax, taking into account not only the aggregate amount of an individual's inheritance but also his pre-existing net worth).

Points out that tax on each "turnover" of property would include sidewise bequests to collaterals as well as vertical bequests to descendants, whether children, grandchildren, or great grandchildren of the decedent. While those who would penalize generation-skipping, such as Professor Casper, contend that estate taxes are avoided by the creation of trusts which "last for 100 years", notes that, in thirty years of continuously drafting trusts, he remembers only one trust which might have lasted that long. Agrees, however, that tax might appropriately be imposed, in accordance with A.L.I. proposals, in cases where the trust corpus could conceivably pass to descendants more remote than grandchildren.

Reiterates that there would be few if any long term trusts, despite tax savings, if the donor could not vest intermediate beneficiaries with tax-free powers to rearrange the disposition of both income and principal to accommodate changing family needs and desires. Concludes, therefore, that if generation-skipping is an abuse, it can be controlled far more simply by restricting the ability of intermediate beneficiaries to control enjoyment of the trust.

Accessions tax

Recommends that any reform of death taxes should include consideration of the inheritance (or accessions) tax as a more equitable and socially effective substitute for the estate tax. Both inheritance and accession taxes levy a graduated tax on the amount received by each beneficiary rather than on the total amount of the decedent's estate; the accessions tax goes one step further by also taking into account the beneficiary's prior net worth. As an example, points out the unfairness of the present estate tax which applies equally to two estates of $250,000—one left to an only child (who would receive $200,000 after taxes), the second divided among five children (who would each receive only $40,000 after taxes).

Expansion of marital deduction

Opposes a 100-percent marital deduction. Points out that it would result in revenue losses, and could also lead to distorted modes of family gifts, "June-December" marriages, and the cut-off of children from a prior marriage in order to give the entire estate "tax-free" to a surviving spouse. Refers, in addition, to the basic rationale of the 50-percent marital deduction adopted in 1948—to equate common law with community property States.

Estate tax deductions for bequests or other testamentary transfers to charity

Opposes any limitation on the charitable deduction. Points out the fallacy of reducing the estate tax deduction to 50 percent merely because there is such a limitation for purposes of the income tax, which ignores the fact that an *inter vivos* charitable gift of appreciated property shelters otherwise taxable income whereas such tax avoidance is impossible with respect to testamentary gifts to charity. Observes also that the testamentary charitable gifts redistribute wealth to and for public uses as effectively and in much the same manner as death tax payments, especially with the restrictions imposed on private foundations by the Tax Reform Act of 1969. Concludes that every effort should be made to encourage maximum testamentary transfers to charity to maintain private eleemosynary institutions for purposes beyond the purview of Government funding, to avoid increasing Government intervention in the private sector, and to preserve private philanthropy.

Richard B. Covey, Carter, Ledyard and Milburn, New York, N.Y. (Panel No. 10):

States that revenue produced by estate and gift taxes is relatively insignificant. Concludes that policy decisions in these areas may therefore be divorced from revenue contributions and may be made with the primary objective of imposing a fair tax.

The basis rule for property transferred at death

States that two proposals for change so far suggested are: *the capital gains tax proposal* to treat death (and perhaps transfers by gift) as a taxable event, and *the carryover basis proposal* to carry over the decedent's basis for assets included in his gross estate to the recipient of the asset and to increase this basis by the estate tax attributable to the unrealized appreciation in the asset at death.

Points out that 10 years ago this committee considered both proposals and rejected each; believes that the decision at that time was sound and that nothing has occurred to justify an "overrule" at this time.

Believes both the carryover basis and capital gains tax at death proposals do not meet the consideration of simplicity of operation. Additionally believes that both proposals do not meet the important consideration of fairness. Feels that the effect of the capital gains tax proposal would be regressive; and illustrates the reason for this belief. Describes unfair results which could occur under the carryover basis proposal.

Position.—Recommends that if a change is to be made for property transferred at death it should take the form of an additional estate tax (AET) on net unrealized appreciation included in a decedent's gross estate, with a continuation of the current basis rule for property included in the estate. Says the AET would be applied at a single flat rate, and would not be deductible in computing the basic estate tax. Believes this justifies an AET rate substantially below the applicable capital gains tax rate. Sets forth details of the AET tax.

Says that an AET has 3 main advantages:

1. *Fairness.*—The AET would be progressive because the entire net appreciation is subject to both the basic estate tax and the AET.

2. *Simplicity.*—Collection and administration would be simplified through combination with the estate tax collection process.

3. *Constitutionality.*—Any problem in this regard would be avoided by the AET, which is an excise tax.

Lock-in problem.—Believes this problem is real, and one that the proposals for change discussed above would not solve. Believes the only solution is a significant tax incentive for sale during lifetime. Suggests an incentive might be an estate tax credit for income taxes paid on capital gains during life.

Estate tax rates and exemption

Says that one school of thought would increase the estate tax exemption to reflect the increase in cost of living in the past 30 years. A second school would decrease the exemption and increase the rate schedule to significantly increase tax revenues.

Believes the revenue loss from increasing exemptions would be too substantial. Also believes proposal to substantially increase estate tax collections is inadvisable. Feels it is undesirable to require a small estate to pay a significant amount of estate taxes. Believes such an increase in estate taxes would compound the existing liquidity problem. Says that granting additional time to pay tax is not a satisfactory solution if the tax is so high that a sale of the business is required.

Position.—Believes the revenue produced by the estate tax should

continue at its present level and there should be an increase in the exemption and restructuring of rates to remove the rapid progression in the current lower rates. Favors estate tax exemption of $100,000, reduced by the portion of a $30,000 exemption for lifetime transfers that is used. Recommends that the increased exemption operate as a credit.

States that approximately 30 percent of the estate tax returns filed show no tax due. Points out the estate tax return is quite long and complex. Recommends development of a short form estate tax return.

Generation-skipping

Points out that a single transfer tax is imposed on outright transfers that skip one or more generations and on transfers in trust even though two or more generations of beneficiaries will enjoy benefits from the trust. Says this result is criticized on the premise that an ideal transfer tax system would impose a tax every generation.

Describes proposals for change set forth by the Johnson Administration Treasury studies, the American Law Institute, and Professor Westfall.

Says that a trust is used by an estate owner to provide flexibility and enable the enjoyment of property to be altered to accommodate changes in circumstance. Says the concept of "family" is important in a discussion of generation-skipping.

Believes the proposals of the Treasury studies and the ALI impose tax at the wrong time on the wrong person and are defective in three respects. First, the additional tax is computed by reference to the transferor's tax rates and is therefore inconsistent with the every generation tax theory. Second, the tax is dependent upon the transferor's rate applicable at the time of transfer; this may create an inappropriate incentive for making early transfers in trust when the transferor's tax rate is low. Third, says permitting the tax to be based on value at time of transfer or at a later date injects aspects of a lottery.

Believes the Westfall approach would produce complexity in the form of an interdependent computation.

Position.—Believes any change should be done in a manner that a person may create a trust having his ancestors, spouse, children, and grandchildren as its beneficiaries without the imposition of an additional transfer tax. Proposes an additional tax applicable to long-term trusts where the property does not "vest" for transfer tax purposes in a child or grandchild at a time no later than the death of the last living child of the transferor. Says the effect of the proposal would be to shorten the period during which trust property may be kept outside of the transfer tax base from as much as 100 years to a period not greater than the lives of children of the transferor.

Unification

Points out that the gift tax rates are three-fourths of the estate tax rates; and that a gift removes property from taxation at the top estate tax rate by payment of a lower gift tax. Says the existing system has been criticized as preferring the wealthy who can afford to make gifts.

Describes the unification proposals recommended in the Treasury

studies. Also describes the proposal to retain the existing dual structure but to enact a simplified unification proposal where the estate tax would reflect the amount of the decedent's taxable gifts and his aggregate gift taxes thereon.

Criticizes several features of the Treasury studies proposals. Additionally criticizes premises on which the proposals were made.

Position.—Favors enactment of the "simplified" unification proposal described, combined with (1) a single transfer tax rate schedule with rates below the current estate tax rates, and (2) a provision taxing as a part of a decedent's gross estate the amount of any gift tax attributable to transfers made within two years of death. Believes the effect of these changes would substantially reduce the present tax incentive in favor of lifetime gifts.

Marital deduction—quantitative limitation

Says that the Treasury studies and the ALI recommend a marital deduction unlimited in amount. Believes an unlimited marital deduction is a judgment that it is appropriate to permit a complete avoidance of estate tax until the death of the surviving spouse. Sees no reason to grant a postponement of all tax in a large estate.

Position.—Believes the most unfortunate aspect of the current marital deduction law is its operation in the case of the owner-spouse of a medium-size estate of between $150,000 and $300,000. Says that to avoid "double taxation" on roughly half the estate, the husband must create a trust or legal life estate of the nonmarital portion and limit his spouse's interest in it to a nontaxable interest.

Recommends liberalization of the marital deduction to permit an unlimited deduction for the medium-size estate. Supports a change in the marital deduction to the greater of $250,000 or one-half of a decedent's adjusted gross estate. Says that this recommendation plus the recommended increase of exemption also suggested would allow as much as $350,000 to be left to the spouse free of estate tax.

Unlimited estate tax charitable deduction

Says that Professor Westfall has proposed a percentage restriction of the estate tax charitable deduction in certain cases. Believes such a result would not produce a parity with the income tax laws and with making gifts during life, and says the failure to allow an income tax deduction does not result in a tax being imposed upon charitable transfers.

Says that two reasons are given for limiting the estate tax charitable deduction—revenue loss and the abuse of gifts to charities operated more for private gain than public benefit. Says the latter reason does not give proper significance to the private foundation rules of the Tax Reform Act of 1969.

Says any percentage limitation on charitable transfers would substantially reduce the amount available for charity through bequests. Believes with any reduction of charitable bequests, the federal government must take up the slack.

Position.—Believes a percentage limitation on charitable transfers is inappropriate because amounts left to charity in excess of the limitation would be taxed. Believes all charitable transfers should be entitled to an estate tax preference.

Insurance

Points out that under present law the inclusion in an insured's gross estate of life insurance proceeds which are not payable to the estate turns on whether he has at death any "incidents of ownership" in the policy. Says this is criticized with respect to ordinary life policies in that the amount includible bears no relationship to the amount contributed in the form of premiums by the insured or the extent to which a given "incident of ownership" conferred a power or a benefit upon the insured. As to group life policies, the criticism is that since the policy has no cash value, no gift or estate tax is ever imposed upon a transfer of such policy during life.

Position—Suggests the continuation of the current "incident's of ownership" tests for life insurance, except in the case of group term life insurance. Would follow the suggestions in the Treasury Studies and by the ALI to view as insurance connected with the individual's employment and to be governed by the rules applicable to employment benefits, whether or not it arises directly from an employment relationship. Believes that these benefits should be included in an individual's gross estate. Points out that the irrevocable designation during life of a beneficiary for a group term policy would not remove the proceeds for the insured's estate and conversely should not be treated as a lifetime transfer subject to tax when the designation is made.

Liquidity

Points out that the provisions in the tax laws to alleviate the problems of liquidity in the case of an estate are criticized as being too restrictive. Points out that if changes are made in estate tax laws on the basis rule property transferred at death, the liquidity problem will become more serious.

Position.—Believes that the proposals made in the Treasury Studies with respect to the liquidity problem are not satisfactory, particularly if the problem is intensified by adoption of a tax on unrealized appreciation at death or by an increase in estate tax rates. Suggests that more is needed to alleviate the liquidity problem.

Makes the following suggestions:

1. Opposes the change suggested in the interest rate (from 4 percent to a rate of 2 percent higher than the Federal Reserve System's rediscount rate) because it would increase considerably the interest payable when the estate tax is obtained.

2. Favors the changes suggested by the Treasury Studies to permit the use of security arrangements rather than bonds and to qualify the decedent's interest in a closely held business as acceptable collateral.

3. Supports the reduction in the percentage requirement to 25 percent of the taxable estate and the elimination of the requirement (in sec. 6166(c)(3)(A)) that 20 percent in value of "voting stock" be included in the "gross estate". Opposes the proposal that installment payments be required quarterly rather than annually as under present law since it would increase the liquidity problem and be more burdensome administratively.

4. Suggests that the word "undue" be eliminated from section 6161 (a)(2) so that an extention of time would be granted upon a showing

of "hardship" as contrasted to "undue hardship" since it is difficult to distinguish the two in many cases.

5. Opposes the proposal of the Treasury Studies that redemptions to meet estate and death taxes and funeral and administration expenses be eliminated since it would worsen rather than improve that problem. Favors the requirement that redemptions (under sec. 303) be available only to the extent the redeeming shareholder is liable for the payment of death taxes, funeral and administration expenses. Opposes any requirement that the taxes (and expenses) be attributable or allocable to the closely held business since it would restrict the choices to the shareowner as to which of his assets to liquidate.

Discussion

Believes that the problems arising out of discretionary trusts are easier to handle under present law than they would be under an accessions tax.

Believes that the marital deduction should not be extended to include property over which the surviving spouse does not have absolute control. Thinks such a rule would create very serious technical problems and is in any case of doubtful equity.

Notes that when a person makes a gift during life he is taking money off the top of the estate tax brackets and putting it at the *bottom* of the gift tax brackets. Thus, for example, the first $30,000 of lifetime gifts are in the zero bracket although the donor may later die leaving a substantial estate.

Suggests it is possible that lowering of the top rate would tend to lessen the desire to engage in various manipulations.

Believes that under an accessions tax many of today's problems would remain.

Agrees that, in limited circumstances, post-death agreements between executors and the Internal Revenue Service should be permitted to correct mistakes in draftsmanship, etc.

Believes that if we had a system under which the property used to make up the marital deduction got a carryover basis, while the property taxed did not, we would run into enormous technical and administrative problems.

James B. Lewis, Paul, Weiss, Rifkind, Wharton & Garrison, New York, New York (Panel No. 10):

Believes that estate and gift taxes play an important role in the tax system. States that they are progressive taxes, that are seen as a limitation on transmission of excessive accumulations of wealth, and are justified as a tax on those who escape their share of income tax during life.

Unification of the estate and gift taxes

Believes that a unified tax is primarily a tax equalizing device. Feels that under the present system people who make substantial gifts pay far less in transfer taxes than those with equal amounts of property transferred at death. Shows how a man with a million dollars of property can save over $100,000 on transfer taxes if he makes lifetime gifts of two-thirds of the property over a 10-year period. States that the following features of present law contribute to the tax sav-

ing: the separate exemptions in the estate and gift taxes, the lower tax rate on gifts than on estates, shifting of gifts out of high estate tax brackets and into low gift brackets, and the fact that the gift tax, unlike the estate tax, is not itself a part of the tax base.

Maintains that a unified tax would eliminate complexities in the law, such as the contemplation of death provisions in the estate tax law, and double taxation, where there is both a gift and estate tax on the same lifetime transfer.

Recognizes that the present separate estate and gift taxes are defended on the ground of encouraging lifetime gifts. Believes that the decision to make lifetime gifts should be made with reference to personal and family considerations, and taxes should be neutral.

Taxation of generation-skipping trusts

Maintains that present law encourages tying up property in trusts for one or more generations. States that the terms of a trust may be drawn to give the beneficiaries a substantial degree of enjoyment, and still the trust will remain immune from estate taxation on the deaths of the trust beneficiaries. Gives examples of powers over trust principal that beneficiaries may have without the trust principal being subject to taxation on their death.

Believes that most people of substantial means feel that, under the present system, they have no choice but to tie up their property in trust for several generations. Feels the tax law should be neutral in this area, and the decision to leave property in trust should be based on personal and family considerations. Warns that resolution of the problem is complex.

The marital deduction

Recommends eliminating the 50 percent limitation on the marital deduction. Believes that this would encourage simpler and sounder estate planning and a more rational and equitable tax system. Believes that with the 50 percent limitation the marital deduction does not equalize tax burdens between community property and noncommunity property States. Additionally recommends that marital deduction be elective, and recommends elimination of the requirement that the wife receive outright ownership.

The rate table and State death tax credit

Believes the rates on the top brackets are too high. Additionally recommends the rate of progression be smoothed out. Indicates that the present state death tax credit is explainable only in terms of history.

Other structural improvements

Supports the American Law Institute recommendations for taxing property held as joint tenants with right of survivorship. Also supports the ALI uniform Federal disclaimer statute. Suggests a review of the estate tax treatment of various types of property that now frequently escape estate tax (as life insurance).

Suggests reexamination of limitations placed on estate and gift charitable deductions by the Tax Reform Act of 1969. Believes that the charitable deduction for remainder interests to charity should be restored. Recommends reintroduction of the annual filing system.

Additionally recommends that changes be prospective so as not to disappoint taxpayers' expectations.

In response to inquiries, made the following comments.

Believes there is a great deal to be said for an accessions tax. Believes the administrative difficulties under an estate tax and accessions tax are about the same. Believes that an inheritance tax is fairer, but it may become more complicated.

Believes that if the top estate tax rate is only 50 percent, estate tax revenues would decrease.

Believes that District Directors usually are reasonable in granting hardship extensions for payment of tax. Nevertheless, states that he has seen sales of businesses that were in part generated by the estate tax problem. Says that the estate tax does have some tendency towards selling out to major corporations.

Deplores attempts by Internal Revenue Service to try to eliminate deductions for charitable remainders on the basis of arguments that trustees might be able to favor the income beneficiary, because believes that in these cases the charitable organizations will receive money when the life tenants die.

Professor David Westfall, Harvard Law School, Cambridge, Massachusetts (Panel No. 10):

States that more revenue should be raised through estate and gift taxes. Today only 2 percent of the Federal revenues are raised through such taxes, whereas in 1939 the figure was 7 percent.

Capital gains at death

Capital gains should be taxed at death. The 1969 Treasury proposal, under which gains not realized during the decedent's lifetime would be included and taxed as part of his final return, should be adopted with certain modifications. The principal argument against taxation of capital gains at death—that such gains are unreal because they simply represent inflation—is not persuasive. The problem of inflation is not confined to the situation where gains are postponed until death, and should be dealt with on a general basis as part of the capital gains provisions. Problems of bunching of income can be dealt with through averaging provisions. Possibly, in the case of capital gains at death, averaging over a 10-year period should be permitted. But the bunching problem is not a reason for failure to tax capital gains at death.

The major alternative to the 1969 Treasury proposal is a proposal to tax unrealized appreciation at death at a flat rate, with no exceptions or exclusions, as an additional estate tax. One objection to this proposal is that in some cases it would create an artificial incentive to hold property until death, whereas in other cases the incentive would work the other way. Also, some exceptions should be made for appreciated property left to widows and dependent children. Moreover, by labeling the tax an estate tax, rather than an income tax, it would make it possible to pay the additional tax by surrendering for par certain U.S. bonds purchased at a discount.

States that liquidity problems of estates should be recognized in the tax Code, but that the existence of such problems was not a reason to allow capital gains at death to escape taxation. There are many instances of unrealized appreciation in estates where there is no liquidity problem. Moreover, the liquidity problem can be handled by allowing a generous period for the payment of tax in cases where such treatment is warranted.

Deductions and exclusions

Believes the marital deduction should be increased to equal $100,000, plus 50-percent of anything in excess of this amount. Also, there should be a limited exemption for property left to minor children. However, in general, the Federal estate tax exemption should be lowered to $20,000 and the estate tax rates should be increased to a minimum of 20 percent. Also, the charitable deduction should be limited to 50 percent of the gross estate. The estate tax credit for state death taxes should also be repealed since it is primarily an outdated form of revenue sharing.

Indicates that the $3,000 annual gift tax exclusion is too generous, especially since this can become a $6,000 exclusion where marital partners join in the gift. The exclusion should be reduced to $1,500 per year to minimize tax avoidance.

With respect to insurance, the law should be changed to provide that life insurance is taxable to an estate, regardless of whether the premiums are paid by the surviving spouse or the decedent.

Generation skipping

To discourage generation skipping, there should be a partial deduction for property which is left outright to a child, because that property is going to be taxed again when the child dies.

In response to an argument that any amendment taxing generation-skipping trusts should not apply to already existing arrangements, points out that in some cases this might mean that the new law would not take effect for 100 years. He suggested that instead of a grandfather clause the beneficiaries of generation-skipping trusts might be given the opportunity to make a tax-free release of their interests in the trust.

Professor A. James Casner, Law School of Harvard University, Cambridge, Massachusetts (Panel No. 10):

Mr. Casner was originally scheduled to be a panelist but was unable to appear. He submitted a written statement which included 45 recommendations of the American Law Institute as a result of a 5-year study project. Some of these recommendations are as follows:

1. There should be no exclusion from transfer taxation, under either a dual tax system or a unified tax, on the death of an employee on the ground that the transferred asset is an employee death benefit.

2. There should be no major change in the present transfer tax rules with respect to powers of appointment, under either a dual tax system or a unified tax.

3. The 100% charitable deduction in the field of transfer taxation should be retained, under either a dual tax system or a unified tax.

4. Under either a dual tax system or a unified tax, an additional tax should be imposed to deal with the problem of the avoidance of transfer taxes by a succession of limited beneficial interests that may continue through several generations.

5. Under either a dual tax system or a unified tax, an additional tax should not be imposed on an outright transfer, or its equivalent.

6. The 100% marital deduction should be adopted in place of the 50% marital deduction, under either a dual tax system or a unified tax.

7. The terminable-interest rule in relation to marital deduction transfers should be abolished and a current-beneficial-enjoyment test adopted, under either a dual tax system or a unified tax.

8. Under either a dual tax system or a unified tax, an election should be available to have qualified marital deduction transfers taxed in whole or in part as though they did not qualify for the marital deduction, and to the extent such an election is made, no transfer tax should be imposed on identifiable previously-taxed property when beneficial enjoyment passes from the donee spouse to others.

9. Gift splitting by husband and wife should be allowed on a transfer by either one to others in connection with deathtime transfers as well as lifetime transfers, under either a dual tax system or a unified tax.

10. A line between completed and uncompleted gifts should be definitively established, so that all lifetime arrangements would fall on one side of the line or the other, and so that there would be no area where the same transfer is subject to transfer taxation both as a lifetime transfer and a deathtime transfer, under either a dual tax system or a unified tax.

11. Under a dual tax system, the present law as to gifts in contemplation of death should be retained, except that when a gift is in contemplation of death, a refund should be allowed for the amount of any gift tax paid thereon, or if the gift tax thereon has not been paid the liability therefor should terminate.

12. A rate schedule, under either a dual tax system or a unified tax, that progresses slowly through the lower taxable amounts is preferable to one that progresses steeply through such amounts.

13. There should be no differential in the rate schedules for lifetime and deathtime transfers under a dual tax system, so as to keep the rates on deathtime transfers as low as possible.

14. An exemption of [$30,000] for the gift tax should be retained and of [$100,000] for the estate tax should be allowed under a dual tax system, in preference to lower exemptions that would permit lower rates in the various brackets in order to produce any required amount of revenue.

15. An annual per-donee exclusion of [$3,000] for present-interest lifetime transfers should be retained, but with an annual per-donor limit of [$15,000] if an exclusion of transfers for consumption is adopted, under either a dual tax system or a unified tax.

16. Any new rate schedule should be effective immediately upon enactment, except that in the event of unification the old gift tax rate schedule should be in effect for inter vivos gifts until the effective date for unification.

17. In the case of any transfer prior to the enactment of the new law which was complete under the old law, no tax should be imposed under any provision of the new law until an event occurs (such as the exercise or release of a power of appointment) that would have been subject to a further tax under the old law.

18. In the case of property transferred prior to enactment of the new law, but which would have been included in the transferor's estate on his death under the old law, the property should be taxed as a

transfer at death under the new law whether or not it would be so treated under the terms of the new law, but there should be a credit for any gift tax previously paid as provided in the present law.

19. Inasmuch as the primary justification for changing to a unified tax system is to keep the rates on deathtime transfers by those who do not or cannot make lifetime transfers at a lower rate than would be possible under a dual tax system, it should be understood by those charged with determining the rate structure, if a unified tax is adopted, that the purpose of the shift to a unified tax would be undermined if the rate structure evolved under it were designed to produce more revenue than would be produced under a dual tax system.

PANEL NO. 11—TAXATION OF FOREIGN INCOME

Jay W. Glasmann, Ivins, Phillips & Barker, Washington, D.C.:

Believes the balance of payments problem is not attributable to the tax treatment of foreign subsidiaries (multinational corporations) because most of the deficit arises from Japan, where Americans cannot generally hold majority control of Japanese corporations, and from Canada, where the deficit is due to the special automative agreement of 1965. Tax changes would not be an answer to trade and balance of payments problems. Instead, foreign investment here should be encouraged, as by temporarily forgiving U.S. withholding tax on transmittal abroad of dividends and interest from U.S. investments.

States that present rules tend to encourage foreign subsidiaries to hold profits in countries having lower tax rates than the U.S., yet to assure that these corporations pay the greater of the foreign or U.S. tax would disadvantage them as compared with foreign-held corporations paying lesser taxes. Expansion and simplification of the DISC proposal would be more beneficial to our export position than would be increasing taxes on foreign subsidiaries.

Maintains that because most countries impose withholding taxes on dividends to nonresidents, forced repatriation of profits would primarily increase revenues of other nations. Furthermore, constitutional problems would arise.

Affirms that U.S. plants abroad that are exporting to the U.S. at least ten percent of their output, however, should be taxed on their U.S. profits to make those enterprises competitively equal to U.S.-located businesses also selling here. Exceptional treatment should be accorded if the product could not have been sold at a reasonable profit if manufactured in the U.S.

Argues that if undistributed foreign income is taxed, foreign subsidiaries should be permitted to be taxed for all other purposes as domestic corporations. Thus, normal rules as to depreciation and setting off of losses of one corporation against another's profits should apply.

Asserts that no drastic changes in the foreign tax credit should be made. To claim that treatment of foreign taxes should be the same as treatment of State and local taxes (for which only a deduction is allowed) is illogical because foreign tax rates are so much higher than greater double taxation would result. Additionally, to treat State and local taxes as a credit would turn over corporate taxation to local governments.

States that, of the alternatives of limiting the foreign tax credit to the overall (income from all other nations) or per country limitation, the overall limitation should be chosen as administratively workable.

Claims continuation of the present level of tax incentive for investments in less developed countries is generally questionable, but

the preference for Western Hemisphere Trade Corporations should be maintained as beneficial to the U.S. balance of trade since the provision primarily serves to promote exports. The DISC provision should be continued or expanded from a 50-percent to a 100-percent deferral privilege on export income, but it should be greatly simplified, at least as to small exporters.

Maintains that, for promotion of the balance of payments, the rule of Subpart F. that taxes the increased investment of a controlled foreign corporation in U.S. property as a dividend to the U.S. shareholder should be eliminated.

Suggests that if the tax exemption for foreign earned income is retained at its present level, it might be best to prohibit foreign tax credit for foreign taxes paid on income exempted from U.S. tax.

States that the exemption for aliens and foreign corporations for U.S. income of ships under a foreign flag should be preserved lest countries with more to gain should also repeal their exemptions. However, there is little justification for treating shipping corporations as less developed country corporations simply because they are incorporated under the laws of Liberia or Panama.

Proposes that in order to prevent unjust double taxation, the Internal Revenue Service should have the burden of proof in suits that would reallocate income between a U.S. corporation and its foreign subsidiary. Also, specific rules should be enacted to denote the limitations of income reallocation by the Service.

States that the present subpart F rules, by going after the true tax haven, provide the appropriate place to draw the line. He added that he might do away with the minimum distribution provisions which permit some sheltering of low tax earnings. He also added that it would be good to review areas such as foreign flag vessels and reinsurance abroad.

Points out that foreign investment abroad does not receive the benefits of the investment credit and ADR.

States that he would retain the present benefits for investing in Puerto-Rico, including the tax-free repatriation of the profits because you would not get a great deal of investment down there if ultimately the income was going to be subject to a 48 percent tax.

Thomas E. Jenks, Lee, Toomey & Kent, Washington, D.C. (Panel No. 11):

Points out that for half a century it was the accepted policy of the United States to promote the free flow of capital and goods in international commerce, and to encourage American participation in this effort through the tax laws. In 1962, however, it was suggested that U.S. tax laws should be neutral in their application to domestic and foreign investment. Indicates that in several important bills before this Congress, these factors are not neutral. Believes that by eliminating the deferral of tax on foreign earnings and repealing the foreign tax credit world wide investment by American nationals would be actively discouraged if not prohibited altogether. Believes that this is wrong, and that the balance of payments and other short-range considerations should not justify a change in the permanent structure of the tax laws. Believes that various incentives should be

reexamined from time to time. Includes in this group the incentives intended to encourage exports and the incentives to assist trade with Latin America.

Deferral of income

Argues that the heart of the controversy is the principle embodied in the U.S. tax law that the earnings of a foreign corporation controlled by U.S. shareholders should not be subject to U.S. tax until repatriated. Defines tax equity as meaning that taxes on persons with equal or similar incomes similarly situated in the same tax jurisdiction should be equal. Defines domestic neutrality as meaning that a U.S. investor's decisions should not be influenced by tax patterns which favor foreign over domestic investment.

Argues that there is a basic concept of our taxation of foreign income which provides that the country in which the income is earned has the primary right to tax it. Believes that deferral is a compromise position and one could argue for lighter taxes or exemption of foreign income from U.S. tax.

It is argued that the U.S. tax law is not neutral in its application to domestic and foreign investment. Argues that domestic investment is highly favored.

Questions how the elimination of the deferral privilege would promote either equity or neutrality in U.S. taxation. Points out that the theoretical effect of the elimination of deferral is zero with respect to investments in developed countries that have tax rates at least as high as the United States. Furthermore, argues that repeal of the foreign tax credit would produce an effective tax rate on such investment approaching 75 percent. Therefore argues that the elimination of deferral would fall primarily on investments in less developed countries where the tax rates are generally below those of the United States. Believes that elimination of deferral with respect to the less developed country investments simply adds to the existing disadvantages of investments in these countries. Furthermore, argues that the elimination of deferral would place U.S. companies operating abroad at a disadvantage as compared with the tax burdens borne by the nationals of other countries operating in the same areas. Argues that to impose the full U.S. tax rate on the income of U.S. owned subsidiaries abroad, when no other major investing nation imposes such a tax on its nationals, creates a clear competitive disadvantage.

States that one of the sharpest criticisms of deferral is that it may encourage the formation of foreign corporations to sell back to the United States products previously made here. Believes that this should be carefully studied, and the principle problem in devising any legislation along this line is definitional in nature.

Indicates that another possible approach to this problem would be the granting of U.S. tax incentives to foreign-owned companies to establish new industries here. Such U.S. tax incentives might take the form of reduction or deferral of U.S. income tax for plants employing substantial labor in designated labor surplus areas. It might also be required that the product be exported so that competition for the U.S. market with higher taxed U.S. companies would be avoided.

Recommends repeal of subpart F

Believes that it is a sound and correct recommendation that the rules in subpart F which tax, as a constructive dividend, the earnings of a controlled foreign corporation invested in U.S. property should be repealed. Believes that the rationale for this tax is difficult to appreciate and is extremely detrimental to the U.S. balance of payments. Believes that it is unnecessary, unjust, and a trap for the unwary. Furthermore, the computations with respect to the dividend limitation are very complex, erratic, and irrational. Argues that this provision should be repealed or at least limited to funds loaned to the U.S. parent of the controlled foreign corporation or to an affiliated domestic corporation. The other subpart F rules defining foreign base company income should not be abandoned or rewritten.

Argues that the subpart F rules should not be abandoned in favor of new rules taxing foreign earnings accumulated in excess of reasonable business needs. Believes that this concept does not encourage repatriation but rather long continued deferral.

Argues that the Committee should seek three objectives in developing basic change, greater simplicity, encouraging repatriation, and attacking abuses of deferral without sacrificing the concept in legitimate business operations overseas.

Suggested modifications to deferral

One alternative discussed is a modified deferral concept under which there would be a minimum overall tax on all foreign earnings. Believes that this approach would greatly simplify the subpart F tax concept. Another possible approach would be to eliminate deferral completely with respect to tax haven controlled foreign corporations by providing that such corporations shall be treated for all purposes as domestic corporations. Believes that this concept should only apply where international tax systems have been or could be abused by flowing income into two tax jurisdictions which have no real connection with the business activity generating the income.

Recognizes that there is a problem where foreign losses are deducted in one year and then, when the operation becomes profitable, a corporation is formed and the profits are deferred.

States that the allowance of a foreign tax credit by the U.S. against its tax rests on the fundamental premise that the country in which the income is earned has the primary jurisdiction to tax it. This principle is recognized not only by the U.S. but by the OECD and by all major industrial nations. Therefore if income is earned in the United States either by U.S. nationals or foreign nationals, the primary benefits and protection are provided here. A tax on the basis of a nationality can be justified on the ground that U.S. nationals including foreign subsidiaries of U.S. companies enjoy access to U.S. capital markets and to the advantages of advanced U.S. technology. But, argues these are secondary benefits. Therefore he argues that in any international scheme of taxation the United States should yield its tax to the source country tax. Furthermore, argues that if the foreign tax credit is eliminated the United States would have to renegotiate every one of its treaties.

Foreign tax credit

Believes that the argument that, allowing a credit for foreign taxes up to the U.S. tax rate encourages foreign countries to raise their tax rates to the U.S. level, is overstated. Argues that in order to qualify tax for credit, the foreign country must raise its tax rates on its own nationals as well as on U.S. nationals operating in its jurisdiction. Suggests that the special situations, particularly in countries where oil or mineral income is earned primarily by foreign companies and special taxes have been levied on such income in lieu of collecting royalties, should be handled on an *ad hoc* or treaty basis.

States that a good case be made for or against the use of either the overall or per-country limitation exclusively. Abuses of the credit privilege are possible under either method. Argues that in considering whether the overall limitation should be removed, consideration should be given that U.S. international companies treat their entire foreign business as a unitary business and the overall limitation accords with these business realities.

Endorses gross-up without exception

Agrees that the gross-up provisions dealing with the foreign tax credit should be applied to dividends from less developed country corporations.

Also discusses the problems of negotiating treaties with less developed countries, and discusses tax-sparing approaches and the approach that extends the investment credit by the United States to particular types of investments or reinvestment in less developed countries.

Shipping income

Would continue the present rules with respect to the exclusion of shipping income of foreign registered ships. However, states that repeal or modification of the exemptions in subpart F applicable to shipping profits on a perspective basis is certainly one possibility. Suggests that one possibility would be to limit the benefits to operating companies and deny the less developed country treatment. Another possibility could be the consideration of extending the benefits of deferral to U.S. companies using U.S. constructed vessels registered under our flag. Also suggests that the Western Hemisphere trade corporation provisions also be studied carefully.

DISC

States that he favors the DISC legislation. States that DISC should not be repealed until it has been given a fair trial or until international rules have been adopted which give our exporters fair treatment in world markets.

Possessions corporations

Suggests that in appraising the possession exclusion provisions, it must be recognized that the internal allocation of U.S. resources is involved. States that a bill similar to the one introduced in the 92nd Congress (H.R. 11158) is desirable.

Earned income exclusion

Does not favor repeal of the provision granting exclusion for earned income of individuals in foreign countries, but recog-

nizes that the provision is anachronistic and perhaps violates the principles of tax equality. Suggests that one alternative might be to require bona fide foreign residence to be determined under the laws of the foreign country rather than U.S. law.

Professor Peggy B. Musgrave, Northeastern University (Panel No. 11):

Describes the major aspects of the problem as: (1) the magnitude of foreign investment, (2) a critique of two major tax provisions, and (3) an economic appraisal of U.S. investments abroad.

MAGNITUDE OF PROBLEM

Points out that in recent years, direct foreign investment of U.S. corporations has averaged around $8 billion a year, including reinvested earnings compared to $30 billion of net domestic corporate investment in the United States. Direct investments abroad have a book value of nearly $90 billion, profits are close to $20 billion, or some 20 percent of total profits of U.S. corporations. U.S. taxes paid on such foreign profits are only 5 percent or less than $1 billion. The output produced by U.S. affiliates abroad is about $200 billion with sales by manufacturing affiliates several times the level of U.S. manufactured exports. Ownership of these foreign affiliates is heavily concentrated, even more concentrated than in the case of domestic production.

EQUITY OF MAJOR TAX PROVISIONS

Points out that although in the domestic setting there is agreement that companies with equal profit should pay equal taxes. In the case of foreign affiliates, the problem is more complex because both foreign and U.S. taxes are involved. Foreign taxes are paid when profits are received by the affiliates but both the timing and the nature of U.S. taxes on such profits are controversial.

Deferral

Points out that the reason U.S. tax does not apply until foreign subsidiaries pay dividends to the parent presumably is that these subsidiaries are not an integral part of the parent corporation. From an economic point of view, this is not a valid reason since control over these profits is in the hands of the parent regardless of repatriation and therefore they should be taxed to the parent when earned by the subsidiary.

Deferral is an advantage only if foreign tax is less than U.S. tax. In 1966, the average foreign profits tax was 36 percent compared to the U.S. rate of 48 percent. Repeal of deferral would increase U.S. revenue by up to $1 billion depending on the payout response. In addition, there would be a gain in equity both with respect to domestic versus foreign investment and with respect to investments in different foreign countries.

Foreign tax credit

Points out that foreign profits and withholding taxes in 1970 were about $4 billion. The efficiency case for crediting is that it secures tax neutrality with respect to the choice between domestic and foreign in-

vestment; and the equity case is that it assures equal tax treatment independent of profit origin provided that equality is defined in terms of total foreign plus domestic taxes. The credit approach is subject to questions on both grounds, however.

Argues that while contributing to efficiency in the worldwide sense, the credit exaggerates capital outflow if efficiency is viewed from the viewpoint of U.S. interest. The return to the U.S. on foreign investment income equals the return *net* of foreign taxes while the return to domestic investment equals the return *gross* of U.S. taxes. This is so because the foreign taxes paid on the foreign profits are lost to the United States whereas the taxes paid on domestic profits accrue to the U.S. Treasury. For 1971, it was estimated that net return on foreign manufacturing investment by U.S. affiliates after foreign taxes was 11.5 percent while the gross rate of return on domestic manufacturing investment was 16.5 percent. Investors, if permitted to credit foreign taxes, will carry foreign investment to the point where gross rates of return are equalized at home and abroad, i.e., further than is desirable from the U.S. point of view. By replacing the credit with the deduction method, the foreign investment decision would be put to a more demanding test and would be limited to that which could furnish a rate of return net of foreign taxes at least equal to gross returns obtained on investment made in the United States.

Suggests that on equity grounds, the deduction approach which treats foreign taxes as a cost as is done with taxes paid to the States under the Federal tax would be appropriate. In this way, tax burdens among companies are equalized in terms of U.S. taxes only.

Suggests that there is an inconsistency in the present law which first permits deferral, and then allows an indirect credit for foreign profits paid by the subsidiary. While the case for deferral seems to imply that the foreign subsidiary is an independent company, the indirect credit approach suggests that the subsidiary is essentially part of the parent company which for purposes of the credit is "deemed" to have paid the subsidiary's tax.

Other provisions

The DISC provision.—This provision was adopted so as not to place the exporter at a tax disadvantage compared to the foreign subsidiary. Suggests that equalization should have been secured by terminating deferral for the foreign investor.

Western Hemisphere Trade Corporation.—Argues that this is a tax preference used by a small number of large corporations which cannot be justified by its contribution to development or to U.S. interests.

Less developed countries corporations.—Suggests that these provisions are not effective devices for dealing with development incentives. It would be preferable to tie deferral to reinvestment in plant and equipment in LDC's.

ECONOMIC ROLE OF FOREIGN INVESTMENT

Balance-of-payments effects

Foreign investment has balance of payments effects on the capital and trade account. For the capital account, the return flow of income from past investments now exceeds capital outflow. Suggests that the

outflow has also served to accentuate the balance of payments crises as they have developed in recent years.

Points out that the effects of foreign investment on the trade account are not clear. Capital export does not necessarily lead to commodity export. Production by U.S. affiliates abroad may serve to displace U.S. exports and even domestic sales in the United States. This displacement effect is more likely since direct investment is U.S. owned and controlled and involves U.S. technology. Also, the corporations which account for the bulk of manufacturing investment abroad are also major exporters. The sales of manufacturing subsidiaries abroad are nearly three times the level of U.S. exports of manufactured products.

Points out that the balance of payments effects of maintaining a share of foreign markets via production abroad are very different from doing so via domestic production in exports. Thus, $1 of exports produces a $1 credit in the balance of payments while $1 of foreign sales by a U.S. producing subsidiary abroad yields only say 6¢ of foreign exchange assuming 20 percent profit margin on sales, a 35 percent foreign profits tax, a 50 percent payout ratio, and a 15 percent withholding tax on dividends.

Effects on level and distribution of U.S. income

Presents the most favorable case for foreign investment by assuming that returns to U.S. capital abroad are higher than in the United States and assuming the tax factor is neutral. In this case the U.S. investor will do better in investing abroad, but the U.S. as a whole may lose. This is because some 40 percent of foreign earnings accrue to foreign treasuries rather than to the U.S. Treasury. For the U.S. as a whole to break even, foreign rates of return before tax (assuming a 40 percent foreign rate) must be 1.7 times U.S. returns.

Argues that while the position of investors is improved, that of wage-earners is worsened. Since there is less capital in the United States income originating here will be lower. Consequently, both labor and capital income originating in the United States will be reduced but labor will not benefit from the increased returns abroad. Thus, labor share of total income will be reduced. In this sense, the cost of foreign investment is borne by U.S. labor while foreign labor gets a bonus.

Argues that the above makes too favorable a case for foreign investment. Direct foreign investment does not reflect generally higher profitability abroad but rather rigidities in the domestic industrial structure. Points out that some observers argue that the U.S. has no choice in this matter, that our comparative advantage in manufacturing is shifting to Europe with U.S. productions shifting towards services. They contend that the U.S. is moving into an era of continued import surplus financed by massive return flows of earnings derived from a growing volume of foreign assets. Disagrees with the likelihood of this forecast and questions its desirability.

Argues that capital export is not a substitute for commodity export and foreign production by U.S.-owned companies is not a substitute for U.S. production. Why should the U.S. pursue a tax policy which

will further reduce its competitive advantage by artificially encouraging the movement of U.S. capital and technology to our competitors among developed countries. Is it desirable for the U.S. to rush into the role of 19th century Great Britain considering the political and economic problems that emerged therefrom? Questions whether the effects of such developments on the division of U.S. income between wages and profits can be disregarded. Suggests that it would be more to our advantage to direct our efforts at improving productivity in the United States and raising the capital stock of developing countries. Expresses concern for foreign trade and sympathizes with the Burke-Hartke bill as it applies to foreign investment. Opposes the protectionist proposals with regard to U.S. trade except as a bargaining device for liberalized trade policies.

REFORM PROPOSALS

Suggests that deferral including DISC should be phased out and the foreign tax credit should be modified so as to increase the tax on income derived from foreign investment. This might be accomplished by: (a) substitution of deduction for crediting, (b) limitation of the credit to one-half the foreign tax, (c) limitation of the credit to one-half the U.S. tax, (d) retention of the present credit combined with application of the 10 to 15 percentage point surcharge on the U.S. corporate rate as it applies to foreign income. (Illustrations and examples showing the effect of these suggestions are contained in the statement.)

Argues that the various studies, including the recent Tariff Commission study, which purport to show that overseas investment is favorable to the balance of payments and to the level of employment in the United States have a major defect. This defect is that the studies assume that there are no alternative investment opportunities in the United States for this capital. Argues that this is not correct, that the United States has not run out of productive opportunities for investment, particularly in view of the emphasis given to a capital shortage in the United States. Studies which attempt to compare the effects of investments abroad with the effects of investment at home show the likelihood of a substantial trade displacement effect plus an unfavorable effect on the productivity of labor in the United States. Moreover, other countries are beginning to question the desirability of foreign investment in their own countries.

In response to a question concerning the imbalance of payments caused by increasing imports of petroleum products suggests we have to quickly develop alternative sources of foreign exchange to pay for them and sending capital abroad is not a preferred method. This costs rather than gains foreign exchange. We need to expand export sales.

In response to a question concerning other countries' treatment of their overseas corporations, points out that in the United Kingdom, the test of a domestic corporation is not only the place of incorporation but also the place of management so that in the United Kingdom there are instances where United Kingdom subsidiaries incorporated abroad are treated as domestic corporations and taxed on an accrual basis.

In response to a question about the direct trade-off between manufacturing abroad and domestic manufacturing, argued that if foreign investments slow down, we would lose only a little bit in foreign markets but maintaining these market shares abroad by foreign production is carried out at great costs to the U.S. economy. In response to the question, wouldn't increasing tax burdens on U.S. firms abroad make it more difficult for them to compete abroad and isn't this inconsistent without at the same time encouraging exports. Argues that the strongest competion our exporters get is from manufacturing abroad by U.S. subsidiaries. Suggests that the most effective way of improving the balance of payments is to slow down capital outflow abroad and thereby generate an increased volume of exports.

Pointed out that production of foreign subsidiaries is highly concentrated in a small number of U.S. corporations. Nearly 80 percent of foreign income earned by these subsidiaries is earned by companies with assets over $250 million, about 400 corporations.

Suggests that the changing tax laws for investment abroad is more in the U.S. interests and in the balance of payments interests than imposing quotas and tariffs.

Suggests that a continuing balance of payments deficit and continuous devaluation of the dollar means a continued deterioration of U.S. terms of trade and hence the real standard of living of the American consumer.

Suggests that international tax administration applied to multinational corporations would be desirable.

Points out that the tariff commission study assumes that there is no alternative use for the capital that goes abroad. Consequently, the results of the study have to be favorable to the balance of payments.

Points out that part of the problem of the dollar in foreign markets is due to the tendency of multinational corporations to transfer large amounts of short-term funds abroad when the dollar comes under attack. Suggests that the elimination of deferral by reducing profitability of foreign investment would reduce the outflow of funds abroad in the short run and in the longer run the reduction in the capital stock abroad would have a favorable effect on our trade balance because this investment competes with exports and domestic production.

In response to a question as to whether DISC benefits should be given to companies which sell to foreign sales subsidiaries which already receive deferrals, pointed out that it is possible to set up a foreign selling subsidiary out of the tax-free profits of a DISC and then it is possible for the company to transfer its producing operations abroad and continue to use the services of the selling subsidiary which was financed by tax deferred profits. In this case, DISC becomes a very perverse form of export incentive. In commenting on Professor Stobaugh's study, pointed out that it shares the deficiencies of other studies which do not compare the effect of the dollar of investment abroad compared to a dollar of investment in the United States. They assume that a dollar of investment abroad is somehow surplus capital for which there is no use in the United States and consequently, it must follow that foreign investment shows favorable results.

Stanford G. Ross, Caplin & Drysdale, Washington, D.C. (Panel No. 11):

Considerations

Listed what he thought were the six most important considerations underlying the tax law applicable to foreign income: (1) equity, (2) revenue, (3) simplicity and administrative convenience, (4) balance of payments, (5) domestic economic growth and employment and (6) foreign policy implications.

Different views of tax equity

Explains that equity has two distinct aspects. One is that U.S. persons should be subject to equal tax treatment regardless of their source of income. To some, this means current U.S. taxation treating foreign taxes as a deduction. The second view is that foreign subsidiaries operated abroad should be accorded tax treatment equal to that of their foreign competitors. To some, this means the United States should provide a complete exclusion for foreign earnings.

Deferral

Suggests that the two views of equity could be reconciled by eliminating deferral and retaining the foreign tax credit provisions. Feels that revising subpart F would be self-defeating because it would perpetuate the game of finding even more clever ways to exploit the continuing availability of deferral. Deferral would impose no burden on foreign businesses which pay a substantial tax since the foreign tax credit would be available.

Deferral is less complex

States that elimination of deferral would solve other problems. For example, taxpayers anticipating start-up losses in foreign ventures use domestic corporations so that the losses can be used to offset domestic income. When the venture becomes profitable, they incorporate the branch in a foreign jurisdiction. Suggests that if deferral is not eliminated some provision is needed to rectify this loss allowance problem. Elimination of deferral might also cause a considerable reduction in the importance of section 482. Further, the scope of sections 367 and 1248 might be reduced.

Indicates that the elimination of the deferral would require procedurally nothing of significance for corporations beyond what they are already doing. Perhaps a simpler calculation than minimum distribution could be provided, thereby improving the situation for many tax credit and computational rules under the minimum distribution overseas businesses. Notes that at present we have special foreign provisions. Adds that consistent with his proposal to require gross-up for all foreign dividends, the law might return to a single method of foreign tax credit computation.

Foreign tax credit

States that the foreign tax credit is a particularly equitable method of accommodating conflicting jurisdictional claims. States, however, that there should be a single basic credit limitation provided. Believes on balance that the overall limitation would be the preferable one. Would provide authority for per-country limitation where foreign governments institute tax systems which discriminate against American operations. Emphasizes that his preference for the overall is in the

context of the elimination of deferral. If deferral is not eliminated, states that the more precise per-country limitation would seem to be more appropriate limitation. His reason was that deferral permits taxpayers a great deal of immediate tax benefits and flexibility in planning to avoid residual U.S. taxes when earnings are ultimately repatriated. Urges that the gross-up method be applied to all foreign dividends.

Minimum tax

States that it can be argued that corporations owned by Americans receive benefits from U.S. nationality and should pay at least some income taxes to the United States. States that he was not in favor of a minimum U.S. tax requirement if deferral was eliminated, otherwise he thought it would be in order.

Special provisions

Indicates that the special treatment for earned income abroad, Western Hemisphere Trade Corporations, DISCs, and China Trade Act Corporations should be repealed. Would retain the special treatment for possession corporations since he views it as a valuable economic development tool for Puerto Rico. Thinks that the bill reported by the Ways and Means Committee in the 92nd Congress, which would have prevented deducting start-up losses in Puerto Rico and the claiming of exemption when profits developed, is appropriate.

Suggests, further, that he would eliminate the special tax rules for less developed country operations in that they have had no demonstrable benefit to the economies of the less developed countries.

Alternatives to deferral

Feels that it is difficult to find a compromise between maintaining deferral and its complete elimination. Views the effort in 1962, as about as good a compromise as could be found.

States that it was very difficult to compare the burden on foreign subsidiaries owned by Americans with foreign subsidiaries owned by other developed countries because of the difficulty of comparing effective rates. Feels that his proposals would have a modest impact on U.S.-owned foreign subsidiaries and, therefore, would not hurt their competitiveness.

DISC

States that one of the main arguments used by the Treasury in support of DISC was that present law provided an inducement to manufacture and sell abroad. Thus, if deferral is eliminated, there would no longer be any need for DISC. States that DISC subsidizes an activity which would occur any way and any export incentive should be granted on an incremental basis.

Monetary impact of present rules

States that the present tax rules, while not being the cause, would tend to cause an excess supply of dollars outside the United States by giving more favorable treatment to foreign investment and by favoring the retention of profits rather than their repatriation.

Professor Robert B. Stobaugh, Harvard Business School, Cambridge, Massachusetts (Panel No. 11):

Stated that his entire testimony is concerned with the tax provisions of the Burke-Hartke bill. Estimates that if the tax provisions of this bill were passed, the following would happen: (1) As a result of the liquidation of many of the U.S. owned operations abroad, U.S. jobs would be eliminated, the balance of payments would deteriorate, and new investment in the United States, research and development in the United States, per capita U.S. income, and U.S. exports would decline; (2) Common stock values in the U.S. stock market would lose some $200 billion. Part of this loss would be suffered by the pension funds of workers. Brighter growth prospects in European and Japanese markets would cause an outflow of billions of dollars from the United States.

Recommendations: (1) U.S. tax laws be revised to insure that tax treatment of U.S. based multinational enterprises be no worse than that received by foreign based multinational enterprises; (2) Taxes on foreign income of U.S. based firms not be increased unless similar increases take place for foreign based multinationals. This means that the tax provisions of the Burke-Hartke bill should be abandoned; (3) Multilateral tax agreements should be negotiated with nations containing headquarters of multinational enterprises to insure a common tax policy.

Why U.S. owned operations abroad help the U.S. economy

Estimates that some 600,000 jobs in the United States are directly dependent on U.S. owned manufacturing facilities abroad. The economic health of the United States depends upon the economic health of its multinational enterprises.

Suggests that even though U.S. enterprise would rather produce at home than abroad, this alternative is not available to them because they would lose their foreign markets to foreign competitors.

Points out that U.S. multinational enterprises export components, finished products and capital equipment to their affiliates outside the United States, which has a favorable effect on the U.S. balance of payments. Believes that receipts from foreign affiliates of fees, royalties, dividends, interest, and other earnings also aid the balance-of-payments and that these income receipts are rising rapidly and exceed the net capital outflow of U.S. foreign direct investors. Points out that the surplus was $3.8 billion in 1970 and projected that it will be $11 billion by 1980 if historical growth rates continue.

Why U.S. owned operations abroad would be unable to compete with their foreign competitors if the tax provisions of the Burke-Hartke bill were passed

Believes that the Burke-Hartke bill has three provisions that would increase the tax burden of U.S. multinational enterprises: eliminating the credit for taxes paid to foreign governments, taxing unremitted earnings of U.S. owned foreign subsidiaries, and requiring straight-line depreciation rather than allowing accelerated depreciation on property abroad. Suggests that any provision which increases the taxes of U.S. multinational enterprises would change the competitive balance of U.S. firms and would place them at a serious disadvantage re-

garding competition with foreign corporations. Believes that the long-run competitive effects of more rapid foreign competitors' expansion would be disastrous to the U.S. owned operations abroad. U.S. multinational corporations would not be able to invest in foreign production facilities to the extent that foreign competitors would.

The effect of the Burke-Hartke bill on the U.S. economy

Suggests that if the Burke-Hartke bill were passed, in its first year U.S. tax receipts would increase beyond those obtained under present law and if the analysis of this bill stopped here, one might conclude that the tax provisions of the bill were favorable to the United States. Extending the analysis, however, profit margins of American foreign subsidiaries would erode resulting in reduced dividend payments to the American parent which in turn would reduce dividend payments to its shareholders who would pay fewer U.S. taxes. Additionally, the slower growth of facilities abroad by U.S. firms would reduce U.S. exports and the receipt of royalties and management fees.

States that research shows that the net effects of the tax provisions of the Burke-Hartke bill would be a reduction in U.S. tax receipts, gross national product, balance of payments, and employment. Believes that within four years of the time the provisions of the Burke-Hartke bill go into effect, U.S. tax revenues would be lower than with present legislation.

The effect of the tax provisions of the Burke-Hartke bill on the value of the common stocks of U.S. companies operating abroad

Estimates that if the Burke-Hartke bill were passed, the values of the common stocks of U.S. companies operating abroad would result in a market value loss of $200 billion.

In response to the statements of the other panelists, especially Professor Musgrave, suggests that the critical question concerns assumption as to whether or not a dollar not invested abroad would be invested in the United States. Cites the recent Tariff Commission report which indicated that domestic investment in the United States is not reduced by the multinational corporations' foreign investment. Also cited the European Community Economic Commission which remarked that "It certainly isn't an exaggeration to maintain that the Europeans themselves generally finance American investments in Europe." Regarding foreign direct investment, Mr. Stobaugh concluded that money for foreign investment is primarily raised abroad and that there has been a net inflow to the United States from that borrowed money.

Suggests that the status quo would be better than the enactment of the Burke-Hartke bill.

Job displacement

In response to the statement that 1 million jobs would be lost in the United States as a result of present trade policy and in response to his own statement that he would prefer the status quo rather than the enactment of the Burke-Hartke bill, Mr. Stobaugh offered the following: Does not agree with the conclusion that all of the losses in jobs is the result of present trade policy. Suggests that part of the problem was due to an overvaluation of the dollar in relation to some of the other

currencies. Suggests that the recent devaluations would help cure the situation. Additionally, suggests that it would be better to have the monetary system adjust the value of the material purchased abroad rather than putting in other kinds of constraints because the other kinds of constraints could cause reactions abroad by foreign countries that will increase their barriers.

Regarding the tax provisions of the Burke-Hartke bill, concluded that if those tax provisions were passed there would be fewer jobs in this country rather than more jobs. States that according to the latest available data, overall employmnt in the United States' electronic industry counting government military, industrial as well as consumer electronics is substantially higher now than it was some years ago.

$4 billion tax break granted to multinational corporations

When asked who should pay the $4 billion tax break granted to multinationals, the response was that he did not agree with the use of the terminology "tax break" and offered his own analysis which he said shows the U.S. government is getting more revenue now than they would if the provisions of the Burke-Hartke bill were to be enacted.

Dollar devaluations

In response to the question, how many devaluations do you think this country can stand overseas. The response was that there is no answer as to how many we can stand. Suggests that the United States could stand quite a few if reference was being made to devaluation against the mark or the yen.

Trade deficit and devaluations

To the questions can devaluations be limited to those countries where there is a terrific imbalance such as the Mid-East; Would we have to balance with the European Economic Community in order to accomplish this or can we restrict this devaluation to just one area, the response was that the effects of the 1971 devaluation and the recent devaluation are not known; one cannot draw conclusions until this information is available.

Trading partners

In response to the statement regarding continuing U.S. devaluation, believes that our trading partners will be discouraged because everybody would like to have a surplus, so anything we do that reduces their surplus in order for us to get a surplus will be discouraged. Suggests that, regarding Japan, policy ought to be implemented to encourage the Japanese to reduce their trade barriers.

Trade and monetary reserves

Believes that trade has grown so much faster than the monetary reserves that now, if it gets out of balance for just a very short time, working capital goes down and central reserves go down to a low level and then there is a run on the currency. Suggests that larger reserves relative to the size of world trade is needed and that if fixed exchange rates are kept, continuous trade problems will result. Recommends that more reserves should be held as Special Drawing Rights (SDRs) and less reserves held as dollars.

Multilateral tax agreements

Suggests that multilateral tax agreements are necessary in view of the fact that foreign countries encourage foreign direct investment more than does the U.S. government. Believes that, as a result of discussions with European executives, European multinational enterprises have much greater freedom to move funds outside the country. Suggests that multinational competition, in the absence of multilateral tax agreements, places U.S. multinational corporations at a competitive disadvantage.

Multinational corporations and currency speculation

In response to the question regarding multinational corporations and speculation in the money market, believes that the potential for speculative profit by multinationals is very, very great and that this can have a substantial impact on central reserves. Nevertheless, does not know of any evidence regarding exactly what their actions have been. States that he does not think there is any evidence to suggest that the Americans are more likely to be financial manipulators than the European managers.

Professor Lawrence M. Stone, University of California, School of Law, Berkeley, Calif. (Panel No. 11):

Urges that the United States abandon its post-war policies promoting free trade and the exportation of U.S. capital and expertise as reflected in anachronistic tax incentives which continue to make foreign investments more attractive than domestic investment and thereby account to a significant degree for current balance of payment problems. Recommends repeal or modification of a number of foreign tax provisions.

Elimination of tax deferrals and reduction of foreign tax credit

Contends that the *sine qua non* of discouraging additional investment of U.S. dollars abroad and repatriating untaxed profits of foreign subsidiaries is to eliminate the deferral of taxes on foreign subsidiaries. Proposes that foreign subsidiaries be taxed in the same manner as foreign branches of domestic corporations. Believes that the foreign tax credit should be changed to a deduction, but recognizes that such action would be viewed as overly drastic and therefore recommends that the credit be limited to 75% and that the world-wide foreign tax election be eliminated, leaving only the per-country limitation. Explains that the world-wide election permits a corporation to obtain a "refund" in respect of excess foreign taxes paid to a country with a rate higher than the U.S. rate by establishing a second subsidiary in a low-tax country. Also points out that corporations conduct foreign loss operations through branches to permit utilization of the loss against U.S. income, while profitable businesses are conducted by subsidiaries and hence incur no U.S. tax unless the profits are remitted to the U.S. parent as dividends. Emphasizes that a reduction in the tax credit will serve as an even greater deterrent to the repatriation of foreign profits unless action is taken to eliminate the right of deferral.

Agrees with Professor Musgrave (1) that income earned by foreign

subsidiaries, even if repatriated, increases the GNP only by an amount net after foreign taxes whereas 100% of the pre-tax earnings of domestic corporations are added to either the public sector (as taxes) or the private sector of the GNP; and (2) that foreign subsidiaries of U.S. corporations are the most formidable competitors to domestic manufacturers of exported goods.

Questions what public policy can possibly justify a continuation of the tax favoritism extended to foreign subsidiaries of domestic corporations—especially in view of current balance of payment problems.

Inconsistencies between U.S. taxation of foreign income and other U.S. policies

DISC.—Points out that the reduction of tax by 50% in respect of the export profits of U.S. companies qualifying under the DISC provisions was intended to increase exports and thus improve our balance of payments position. Notes, however, that no steps have been taken to curtail the export of our increasingly scarce timber and petroleum resources.

Foreign Exploration and Production of Oil.—Deplores the fact that U.S. subsidized the development of foreign oil fields by allowing U.S. corporations to claim percentage depletion and also to deduct intangible drilling expenses against U.S. income, but has heretofore blocked the importation of the low-cost oil which was thereby produced; current efforts to alleviate U.S. shortages have met with a demand by a cartel of these subsidized countries for prices many times in excess of production costs. Urges immediate steps to repeal further tax incentives to the development of foreign oil reserves and the employment of such resources to develop U.S. oil and gas reserves as well as alternate energy sources.

Policies discouraging the outflow of capital

Notes that our long-standing tax laws have encouraged the investment of capital abroad, as discussed above, whereas more recent policies penalize such outflows—the Federal Reserve Bank's program limiting foreign loans by U.S. commercial banks, the Interest Equalization tax, and controls on direct foreign investments. In addition, the investment tax credit and the Asset Depreciation Range system are generally limited to domestic investments.

Other inadequacies of present law

Discusses at greater length several problems noted above, including (1) inequities and decreased tax revenues resulting from the world-wide foreign tax credit election; (2) oil royalties disguised as taxes eligible for the foreign tax credit; and (3) the artificial distinctions between allowing a credit for foreign taxes as opposed to a deduction for state and local U.S. taxes. Other inadequacies include (4) foreign tax credit carryforwards and carrybacks whereby income from low-tax countries can be artificially sheltered against U.S. taxes for prior and subsequent years to the extent of taxes paid to other countries whose tax rates exceed U.S. rates; (5) failure to gross-up dividends from less developed countries which results in no benefit to the LDC or the U.S. company whether the LDC tax rate is zero or

48% and a maximum 6-point advantage to the U.S. company if the LDC rate is 24%; (6) exemption of income earned abroad by U.S. citizens; and (7) preferential tax treatment accorded to Western Hemisphere Trade Corporations, China Trade Act Corporations, and income from U.S. possessions.

Recommends that all of the foregoing exemptions or preferences be repealed or otherwise brought into line with current U.S. policies limiting the outflow of U.S. capital.

Panelists Arranged Alphabetically

[1] Prepared statement coauthored by Prof. Edward W. Erickson, North Carolina State University, and Prof. Stephen W. Millsaps, Appalachian State University.
[2] Prepared statement coauthored by Prof. James C. Cox, University of Massachusetts.

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